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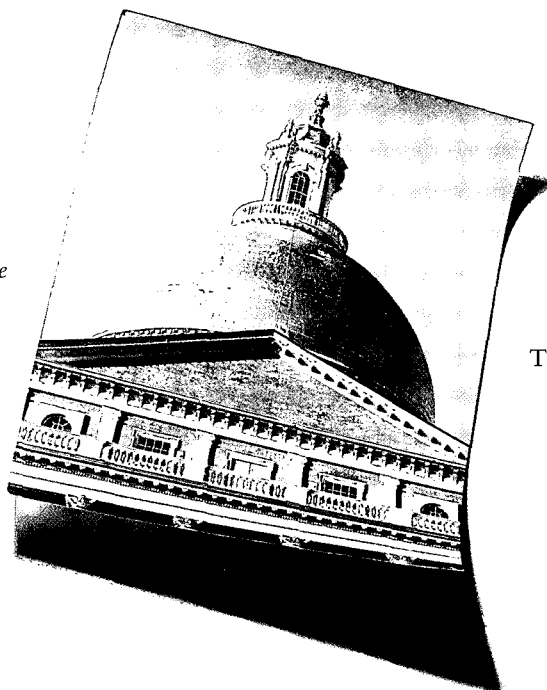
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Corporate “Owners” Speak Out



■ I take strong exception to both the reasoning and conclusions of Margaret Blair in her article, “Corporate Ownership” (winter issue).

Blair advances the familiar stakeholder theory, where shareholders’ interests are only one of many corporate interests. This theory delights corporate managers, who are now liberated from any accountability to any specific party for their performance. Blair seems to think that corporate managers would attend more to the interests of workers if the corporation were not “owned” by shareholders. This is a very naive hypothesis. Our own experience is that in the absence of a shareholder voice (non-voting share, etc.), corporate managements simply please themselves.

Our concern as shareholders is whether the corporation is a profitable and competitive enterprise and whether the management is accountable to their shareholders. If management is not accountable to shareholders, then to whom are they accountable? Without clear definitions of accountability, managers would simply be

politicians, playing off one constituency against another.

A share of common stock is an unusual contract—it relies entirely on an outside body of law that defines the rights of other stakeholders (consumers, labor, suppliers, etc.), as well as the statutory rights of shareholders. The alternative is a series of individual contractual relationships between investors and corporations, such as oil development contracts, pipeline financing agreements, etc., all of which are unwieldy and cannot respond to unexpected changes. According to the traditional concept of equity, it is the most subordinated of all capital, but is the residual beneficiary of both the corporation’s risks and returns. Blair would like to modify the shareholder’s position and add the claims of other parties ahead of the shareholders. The shareholders’ reaction is obvious. They will try to defend their position against further subordination by law or contract. If that fails, then the markets will quickly react to the lower profits and higher legal risks, the prices of stocks will fall,

and the cost of capital for all corporations will rise.

Roland M. Machold, Division of Investment, New Jersey Department of the Treasury

Apples and Oranges

■ Margaret Blair makes the mistake of comparing legal apples with economic oranges when she criticizes share ownership as the basis for corporate decisionmaking. She ends up with the worst of both worlds, using the language of economics to talk about rights and the language of law to talk about money, and does a disservice to both.

In legal terms I own my house, even though the bank contributed far more capital than I did. As the owner I have a lot of authority over what happens to my house, despite zoning laws and insurance requirements and many other kinds of restrictions. Shareholders own the company, despite the fact that their rights are restricted. These restrictions are the trade-off, as both a matter of law and economics, for limited liability. But that does not mean that they are not owners or that ownership should not have rights.

Instead of the “powerful, almost moralistic meaning” of the legal term “owner,” the focus of both law and economic analysis should be on making sure that the system minimizes conflict of interest and free rider problems to create meaningful accountability, which is essential for the total wealth maximization Blair correctly identifies as the top priority. In this context, the ultimate virtue of ownership-based governance is that no other “interest group” can insist on meaningful accountability over the long term. As discussed fully in her upcoming book, the employees Blair is concerned with are themselves the real “owners” of the company, through

their pensions, the largest accumulation of investment capital, with an investment horizon that is by definition long-term. This makes the attempt to put employees and shareholders in different categories a distinction without a difference.

All of the interests Blair identifies will be served if the primary commitment is to long-term shareholder concerns. If the commitment is to anything else, though, the lack of accountability will result in short-term, unfocused, expedient decisions that will in the long run benefit no one. I believe that her focus on total wealth maximization is entirely compatible with an ownership-based governance system, and that, aside from her concerns about the terminology of ownership, her approach to evaluating the issues facing corporate decisionmakers (managers, directors, and shareholders) is very worthwhile.

Nell Minow, LENS, Inc.

Those Embarrassing Democrats

■ A senior administration official commented to me how embarrassing it is that fellow Democrats are so often ill-informed on business and financial issues. I suggested he avoid Margaret Blair’s recent article.

I told him she suggests that company shareholders are not “real” owners because modern corporate structure is more complicated and less tangible than something a caveperson could drop on her foot.

In other words, since a well-run company must handle many interests, including those of customers, suppliers, workers, managers, bondholders, and communities, the interests of shareholders cannot, somehow, be those of owners.

No one suggests a group of carpooling neighbors who buy cars collectively aren’t real

owners just because they don't stake individual claims to the mufflers, agree to written ownership terms, hire chauffeurs and managers, and care about their "bondholders" (the finance company), their employees, their suppliers (mechanics), and their community (police and taxpayers). These arrangements don't make them non-owners. They make them smart owners.

Shareholders are the only corporate constituency with no protection other than their ownership stake, which is already subject to limitations inevitable with complex, traded, interests in perpetual, partially tangible property. Bondholders, employees, customers, and suppliers have contracts. Communities tax and pass laws.

Blair contrasts unreal company ownership with real ownership in "real property." My aunts inherited a house subject to estate interests, beach easements, zoning restrictions, environmental requirements, and management contracts. Their interests are nevertheless those of owners, just owners of things in a modern world. Clearly Blair does not live in a coop.

*Sarah Teslick, Council
of Institutional Investors*

Awaiting the Millennium

■ Margaret Blair's argument that corporate ownership rights as currently conceived fail to protect the "investments" of participants other than shareholders makes sense to me. The problem is squaring her solution with current reality.

Even accepting Blair's critique, it will take a very long time for the courts and society to come around to recognizing the residual claims of stakeholders who are not also shareholders. So what can we do about the situation now?

It seems to me that the best way to make progress toward Blair's ideal is to make it easier

for those who are making "specialized investments" in a corporation to become *actual shareholders* with equity stakes commensurate with their risk. In companies such as United Airlines and Polaroid, certain employees took salary cuts in exchange for shares in an employee stock option plan. Skilled, experienced employees are compensated, in part, with equity shares in thousands of other companies as well. In many of these companies, employee shareholders are also assuming responsibilities for improving corporate performance through such mechanisms as employee committees, work teams, and even board seats. Not surprisingly, companies that combine employee ownership with active employee participation programs are regularly besting their competition.

In her upcoming book Blair gives several examples of companies that seem to have reached her ideal of appropriate sharing of risk and ownership within the existing governance system. I think we should be doing everything possible to encourage this kind of "ownership" while awaiting Blair's millennium. This could include such things as using stock options and bonuses throughout the corporation, more employee-owner involvement in corporate governance, and even further tax incentives to encourage employee ownership.

*Michael Higgins, Foundation
for Enterprise Development*

Employee Ownership Works

■ Margaret Blair makes an essential argument. In a privately held company, owners have a very distinct web of relationships to their company, their suppliers, their customers, their communities, and their employees. They often live where they work. They usually view

ownership as a very long-term investment.

The owners of a public corporation are very different indeed. They have little real interest in the company other than whether it will do better or worse *than expected* (note the issue is not how well it does, because stock value changes based on performance relative to preexisting expectations).

At the same time, management at these companies hums the mantra, "We are a people company first." Which people? As Blair points out, legally, it is the shareholders. But practically, if the company is to succeed, it must be the employees. Blair is absolutely correct that these interests have often clashed, at least in the short run. While management is off meditating on the values of high-involvement management, the public is bemoaning the lack of a long-term perspective in American firms. Why should they have a long-term perspective when their owners don't?

Blair is right in saying we have to align things much better. If people really are the critical resource in a company, and they obviously are, and if the economy can only perform at optimal levels if companies focus on the long term, then what ownership structure will get us there? If the employees were more significant owners in companies, that might well do the trick. Employees are not in it for the next quarter, so as shareholders they are much more likely to resemble the "owners" the prevailing mythology enshrines.

The good news is that when companies do this, everyone does win. Over the past three years, tracking of the stock price performance of public companies with more than 10 percent broad employee ownership shows that these shares consistently outperform those of non-employee ownership companies. Moreover, other

studies show that the combination of broad ownership and participative management practices results in dramatic gains in corporate performance. The barriers to broader employee ownership can be significant, but none is as important as the elitist view that the current ownership structure is both inevitable and good.

*Corey Rosen, National Center
for Employee Ownership*

Margaret Blair replies:

■ I'm a bit puzzled by the intense reaction my article has provoked, because I never said that shareholder rights should be abridged. I happen to think that, in the right context, shareholder rights should be quite strong. But, from a public policy standpoint, it is important to talk about what rights and responsibilities should be assigned to shareholders (and to others) to maximize the chances that corporations will perform well and contribute to overall wealth creation. Simply calling shareholders the "owners" of corporations conveys little or no economically meaningful information to help us decide these questions. Indeed, as some of these letters illustrate, it can be a knee-jerk reaction that stops debate and gets in the way of clear thinking about the allocation of rights and responsibilities.

The securities that shareholders own are, as Roland Machold points out, complex contracts. Shareholders put up "equity" capital that cannot be recovered except by means of some sort of claim on the earnings, or "residual" revenue from the enterprise. But the central point of my article is that every participant in a corporate enterprise who makes "firm-specific" investments is in exactly the same economic position. They cannot recover their investments except by means of some claim on the economic

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Editor

Brenda Szittya

Production

Susan F. Woollen

Proofreader

Ellen Garshick

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“residual” generated by the enterprise. U.S. companies have traditionally rewarded, encouraged, and protected such risky firm-specific investments by employees or other parties by promising to pay them well, and by giving directors and management some discretion in looking out for their interests. That may not be the best system because the promises may turn out to be unenforceable in the long run. Moreover, it invites abuse of the type Machold has in mind when he accuses me of advancing the “familiar stakeholder theory” in which accountability is so diffuse as to be nonexistent.

In my forthcoming book I argue that employees or others who make firm-specific investments should be compensated for those investments with shares of stock, rather than with fat compensation packages that may later turn out to be unsustainable. If corporations really did that, I would be as strong an advocate for shareholder rights as anyone. But since most companies do not, we need to be very careful about policies predicated on the assumption that maximizing share value necessarily serves society’s interest by maximizing total wealth created by the enterprise. It just ain’t necessarily so.

Crime Reform in Virginia

■ Criminologists and corrections experts have finally discovered what the average citizen has long known—a criminal behind bars cannot perpetrate crimes on society. Anne Piehl and John DiIulio (“Does Prison Pay?” Revisited,” winter issue) make this point with some analyses similar to the ones we used in formulating our plan to abolish parole. However, their assertion that we were “too tough by half” does not take into consideration the entirety of our new system. We not only abolished pa-

role, we also targeted violent and repeat offenders through the use of historical time served and recidivism data in our sentencing guidelines—increasing their time served by 100-500 percent. Previously, the average first-degree murderer was sentenced to 35 years and served about 10. Now that murderer will be sentenced to 25 years and serve 25. Abolishing parole does not mean increasing time served for nonviolent drug or property offenders. The Virginia system maintains the time served for those offenders, but houses them in a work center at about half the cost of a medium-or maximum-security cell.

In Virginia we realized just how much prison pays by looking at what repeat offenders were costing taxpayers in one year alone—\$658 million. That’s about what we will spend on building prisons over the next decade. The new sentencing system will also reap \$2.7 billion in direct cost savings to victims over the next 10 years as a result of preventing at least 119,000 crimes, including 478 murders, 3,720 rapes, and 11,387 aggravated assaults.

The overarching benefit of our new criminal justice system, though, is that is is honest. Judges no longer have to play calculator guesswork with sentences. Police officers will not see the same armed robber out on the street only a year after their last arrest. Criminals will know that they cannot “beat the system.” Crime victims and their families will see justice done, and no one can put a price on that.

George Allen,
Governor of Virginia

Offenders in the Community

■ Anne Piehl and John DiIulio present a strong case that prisons are generally good investments when crime costs are weighed against operational

costs except long terms for drug offenders, which demonstrate few crime savings. Legislators everywhere should read these findings before their next votes on mandatory sentences. They should also pay attention to a passing comment by the authors: the large majority of known offenders are not in prison but in the community, on probation or parole.

Of the 5 million Americans under correctional supervision today, only 1 million are in prison. These figures don’t include juvenile offenders. The sheer weight of numbers argues that we would do better to investigate improving community corrections than to focus on marginal changes in prison capacity. Even doubling our prison capacity would leave 3 million offenders under a community supervision framework.

Conservatives should feel free to propose deterrence-based solutions, and liberals to propose rehabilitative ones. Some new technologies might even help out. In all cases, cost-benefit frameworks like those used by Piehl and DiIulio should be employed to assess public expenditures against public safety. One fact stands for all sides to remember: offenders not in prison have more effect on safety than those who are.

Edwin Zedlewski, National
Institute of Justice

Correction

Table 2 in John D. Steinbruner’s “Reluctant Strategic Realignment” (winter issue) contains a typographical error. Under the heading “Army divisions,” the number of MRD units should be 61, not 16. We regret the error.

The Review welcomes comments from its readers. Letters will be edited to conform to style and space.

Tax Cuts: Dessert before the Spinach

BY BRUCE K. MACLAURY

"Frankly speaking, given a \$250 billion federal budget deficit, if there is one thing Americans don't deserve, it's a tax cut." The words are those of Barry Bosworth, senior fellow at Brookings, in testimony before the House Ways and Means Committee in January. But the sentiment is shared by more Americans than Congress seems ready to acknowledge.

Two years ago, in this space, I praised newly elected President Clinton for proposing, in his February 1993 economic message, a package of spending reductions and tax increases that for the first time in more than a decade of rhetoric took a real swing at reducing the federal budget deficit. After much wrangling, Congress passed and the president signed into law a reasonable approximation of that package, one that promised to shrink the deficit by a total of some \$433 billion over the succeeding five years. And believe it or not, those savings have been coming in on schedule.

Not long ago a reader sent in that two-year-old column and asked, "What's your view today?" Fair enough. My response comes in several parts. First, as I said at the time, the president's proposals were designed to *reduce* the deficit, not eliminate it. Second, projections at the time made clear that deficits would rise again in the future if medical costs were not curbed through health care reform. That failed effort is now history. Third, I think mainstream economists had it right: the prospect of significant deficit reduction brought down long-term interest rates, stimulated a housing, auto, and investment boom, and set the stage for a prolonged recovery and expansion that have reduced unemployment to the lowest level since the late 1980s. Not bad, especially since the Fed-

eral Reserve has tightened credit enough to forestall inflationary excesses.

On balance, then, I still give high marks to the first two years of the administration's macroeconomic performance. The interesting debate, however, is not about the past, but about the future. And there I am much less optimistic. Whereas President Clinton deserved credit for a realistic economic vision two years ago, it now seems clear that deficit reduction has given way to "political reality" in the form of a bidding war on tax reductions. The similarities to the first Reagan budget in 1981 are hauntingly familiar—Democrats jumped on the Reagan tax-cut bandwagon, with disastrous fiscal consequences for the ensuing decade. One superficial difference is that supply-side economics was supposed to save the nation from its fiscal follies in the 1980s; today we propose to rely on the straitjacket of a balanced budget amendment.

As Bosworth and others have pointed out, Congressional Budget Office projections indicate a budget deficit of around \$250 billion in fiscal year 1995 (exclusive of the Social Security surplus), rising to about \$380 billion by the end of the decade. That projection already assumes no new government programs, lower health cost inflation, and reductions in discretionary spending of about 3 percent annually through fiscal year 1998. If, as proposed by the Republicans, defense spending is exempted from further cuts, Social Security is "off the table," and interest is still paid on the federal debt, half of all budget expenditures are off-limits. That means that even without *any* tax cuts, Congress will have a major task in finding spending cuts in entitlements—especially Medicare and Medicaid—and discre-



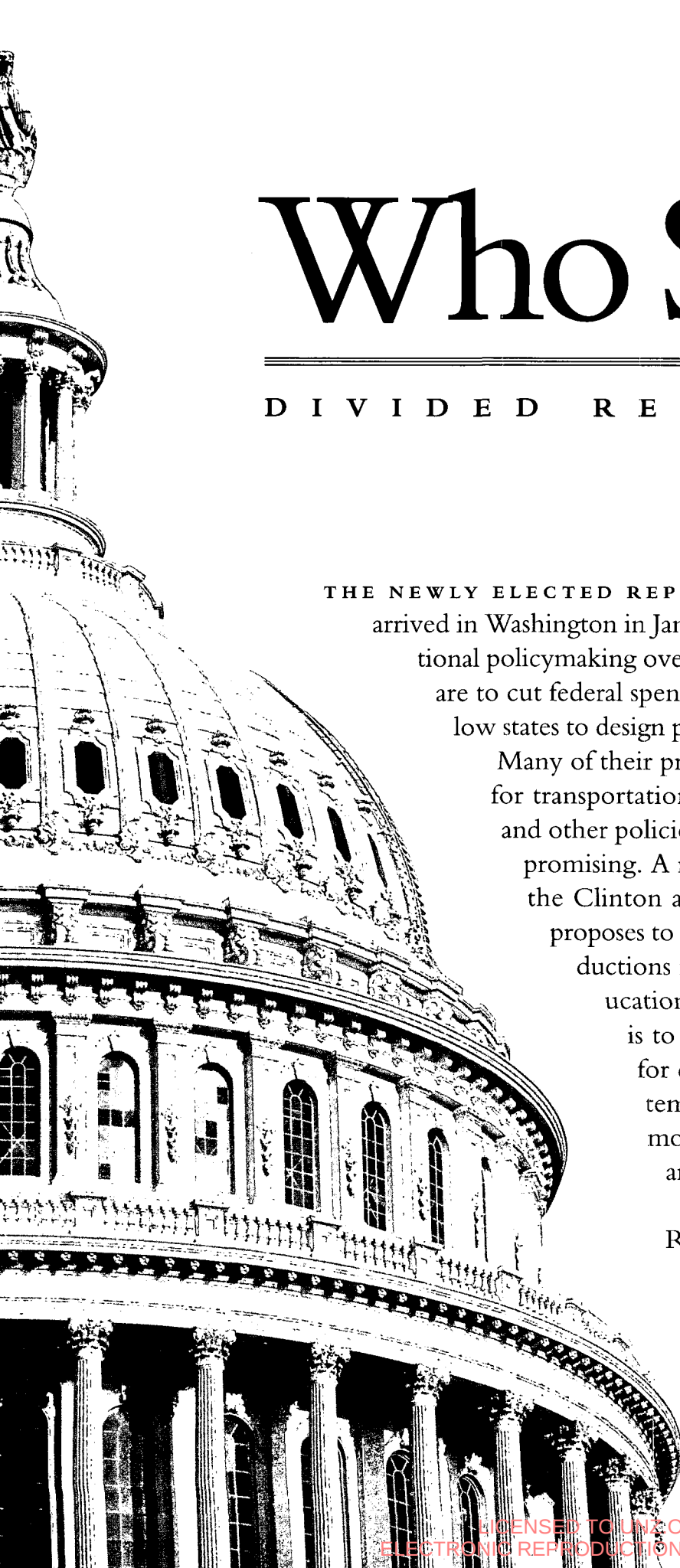
tionary programs to make any further progress whatsoever toward lower deficits.

With respect to the specifics of the tax cuts proposed in the Republican "Contract with America," the most important point to make is that while the projected revenue losses may look manageable in the first five years (*only* \$40 billion annually on average), Treasury estimates show the losses more than doubling (to more than \$100 billion annually) in the subsequent five years. Not even draconian reductions in the vulnerable half of budget expenditures can offset this kind of arithmetic juggernaut. The best that can be said of the corresponding Clinton budget proposals is that they are more of the same, only less so—smaller tax cuts, smaller spending cuts, and a leftover for deficit reduction.

The sad irony is that many Americans really are dissatisfied with welfare as we know it, with an underperforming education system, with unsafe streets and

deteriorating communities, with stagnant wages and a growing gap between rich and poor. Solutions, if they are to be found at all, will require investment—in both public and private sectors. And investment will require adequate saving. Opinions differ. But my understanding of the evidence is that loophole-filled Individual Retirement Accounts and lower tax rates on capital gains will lower revenues, increase deficits, and on balance reduce saving, not enhance it. Will the much-talked-about middle class, or even the rich, for that matter, truly be better off with tax cuts that the nation, especially future generations, can ill afford? Why not get serious about curbing the growth in the national debt, and then debate what kind of tax cut we'd like to enjoy? ■

Bruce K. MacLaury is president of the Brookings Institution and has served in that capacity since 1977.



Who Should

D I V I D E D R E S P O N S I B I L I T Y

P A U L E . P E T E R S O N

THE NEWLY ELECTED REPUBLICAN-CONTROLLED CONGRESS arrived in Washington in January determined to turn a great deal of national policymaking over to the states. The Republicans' twin goals are to cut federal spending on state and local programs and to allow states to design public programs to fit their particular needs.

Many of their proposals—giving states more responsibility for transportation, job training, education, crime control, and other policies that affect economic development—are promising. A number are rightly winning the support of the Clinton administration. Indeed, President Clinton proposes to finance a tax cut by means of substantial reductions in federal spending on roads, housing, education, and flood control. For example, money is to be saved by combining 30 separate grants for construction and repair of mass transit systems, highways, airports, and railroads into a modest, if unified, transportation grant to states and localities.

The convergence of interest between the Republicans and President Clinton results partly, of course, from the enormous pressure exerted on federal spending by demands for tax cuts, the rising cost of senior-citizen entitlements, and the budget deficits piled up during the 1980s. But it also reflects an important

Do What?

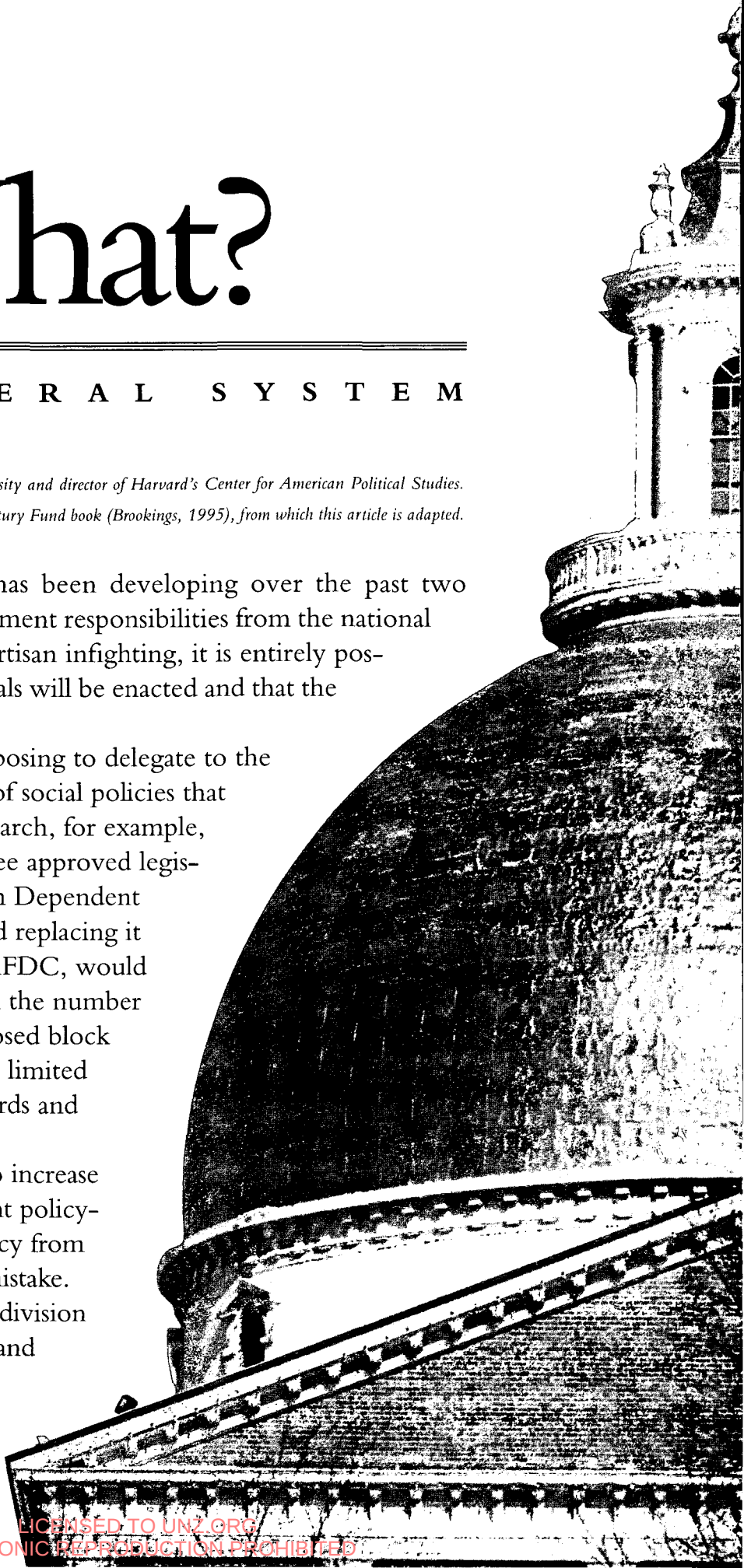
I N T H E F E D E R A L S Y S T E M

Paul E. Peterson is professor of government at Harvard University and director of Harvard's Center for American Political Studies. He is the author of What Price Federalism?, a Twentieth-Century Fund book (Brookings, 1995), from which this article is adapted.

trend in American federalism as it has been developing over the past two decades—a shift in economic development responsibilities from the national to the state and local level. Despite partisan infighting, it is entirely possible that some version of these proposals will be enacted and that the shift will continue.

But Republican leaders are also proposing to delegate to the states responsibility for a broad range of social policies that serve low-income citizens. Early in March, for example, the House Ways and Means Committee approved legislation eliminating Aid to Families with Dependent Children, an entitlement program, and replacing it with a fixed block grant that, unlike AFDC, would not increase or decrease depending on the number of welfare recipients. Under the proposed block grant program, states could set, within limited guidelines, their own eligibility standards and benefit levels.

Unlike the Republicans' proposals to increase the state role in economic development policy-making, transferring redistributive policy from Washington to the states would be a mistake. It would defy the logic of the existing division of responsibility between the national and state levels of government and give states responsibility for a policy role for which they are unsuited.



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Dividing Public Responsibilities

As relations between state and national governments have evolved over this century, the two levels of government have—for very good reasons, as I shall explain shortly—taken distinctively different domestic policy roles. Traditionally, states and localities have taken responsibility for managing the country’s physical and social infrastructure—roads, education, mass transit systems, public parks, police and fire services, and sanitation systems—necessary for the country’s economic growth. I shall call these kinds of policies *developmental* because without them economic progress would be retarded. The national government, by contrast, has taken responsibility for transferring economic resources from those who have gained the most from economic development to those who have gained the least—the elderly, the disabled, the unemployed, the sick, the poor, families headed by single parents, and others lacking in material resources. I shall refer to these policies as *redistributive* because they shift resources from the “haves” to the “have-nots.”

Since 1962, developmental spending at the state and local level has been more than double that at the national level. In 1962, state and local spending was 9.4 percent of gross national product as compared with 4.2 percent for national spending (figure 1). Despite growth in the size of the domestic responsibilities of the national government in subsequent decades, Washington still spends less than half as much on development as the lower tiers. In 1990, the states and localities were spending 10.8 percent of GNP on the country’s developmental infrastructure, while the national government was spending only 5.2 percent of GNP.

With regard to redistributive expenditure, the story is entirely different. Since 1962, the state and local share of the country’s spending on the elderly, the poor, and the needy has steadily declined. While national government redistributive spending more than doubled, from 4.9 percent of GNP in 1962 to 10.3 percent in 1990, state and local redistributive spending edged up only slightly, from a very low 2.2 percent of GNP in 1962 to only a slightly higher 3.5 percent in 1990. The modest increment at the state and local levels is particularly striking, inasmuch as this was the period when the civil rights movement awakened the country to problems of poverty, the Great Society was introduced, and entitlements became an entrenched part of American social policy. Yet the percentage of state spending devoted to redistribution increased only from 28.9 percent to 33.0 percent. And at the local level the increase was barely detectable, from 13.5 percent to 14.1 percent.

State and local reluctance to participate in the redistributive movement can hardly be attributed to the political climate. Over most of this period Democrats controlled at least part of state government in most states, and they held unified control over both houses of the state legislature as well as the gubernatorial chair in many. And despite the intent of today’s congressional Republicans to transfer

welfare policy to the states, there is no indication that states are becoming either more suited for or more capable of such policy.

To the contrary, the division of responsibility between national and state governments is growing more pronounced, as each level of government has learned to concentrate its spending on the things it does best. States and localities, ever more constrained by market forces, are increasingly competent at making choices affecting state and community development. But state and local capacities to care for the needs of poor and disadvantaged citizens have been diminishing.

Economic Development Engine

Local governments are efficient mechanisms for supplying most of the physical and social infrastructure needed for economic development. In providing roads, schools, sanitation systems, and public safety to their residents, local governments must be sensitive to local businesses and residents. If they ignore them, people will vote with their feet and move to another town. Since 17 percent of the population changes its residence each year, the effects of locational choices on property values can be quickly felt. Moreover, if a locality makes a poor policy choice, its failure will soon become apparent and will be ignored by other communities. If it chooses wisely, its policy will be copied—and thus be disseminated throughout the federal system.

Not all local policies will be identical, of course. People vary in their tastes and preferences. Some towns will provide sex education in their schools; others will not. Some towns will ban smoking in stores and restaurants; others will be more permissive. Some towns will emphasize country lanes for walkers and joggers; others will concentrate on playgrounds and baseball diamonds. Part of what makes local government efficient is the variety it provides for people choosing a place to live.

Developmental policy cannot be an exclusively local prerogative, however. For example, major systems of transportation, air and water pollution control, and some forms of higher education must be coordinated across a substantial geographical area. Thus state governments, too, are significant participants in economic development.

The national government, on the whole, is the least efficient provider of economic development. Unlike states and localities, it operates under few market-like constraints. It need not fear that a series of poor economic investments will cause citizens to move to another country. But without market signals to help guide policy choices, development easily degenerates into political “pork” that does little to spur national economic growth. Proposals to create a national industrial policy have generally gone nowhere—in good part because proponents cannot convince policymakers that national bureaucracies can allocate scarce economic resources wisely.

Washington did enlarge its developmental responsibilities during the 1970s, largely through grants to state and local governments. Federal dollars were

given to cities and towns to help build roads, fight crime, improve schools and redevelop deteriorating central business districts. Members of Congress delighted in taking credit for securing federal dollars that helped build bridges, dams, tunnels, and colliders. Joe McDade of Scranton, Pennsylvania, ranking Republican on the House Appropriations Committee, may have been one of the all-time winners. He secured federal monies to help build a center for the performing arts and fund a microbiology institute for cancer research at the University of Scranton (even though it has no medical school and few research scientists), restore an antique aqueduct, construct McDade Park (including a tourist-friendly museum on the history of coal mining), turn the home of second-rate author Zane Grey into a national monument, finance a flood-control project, and convert a railroad station into a fancy hotel and restaurant.

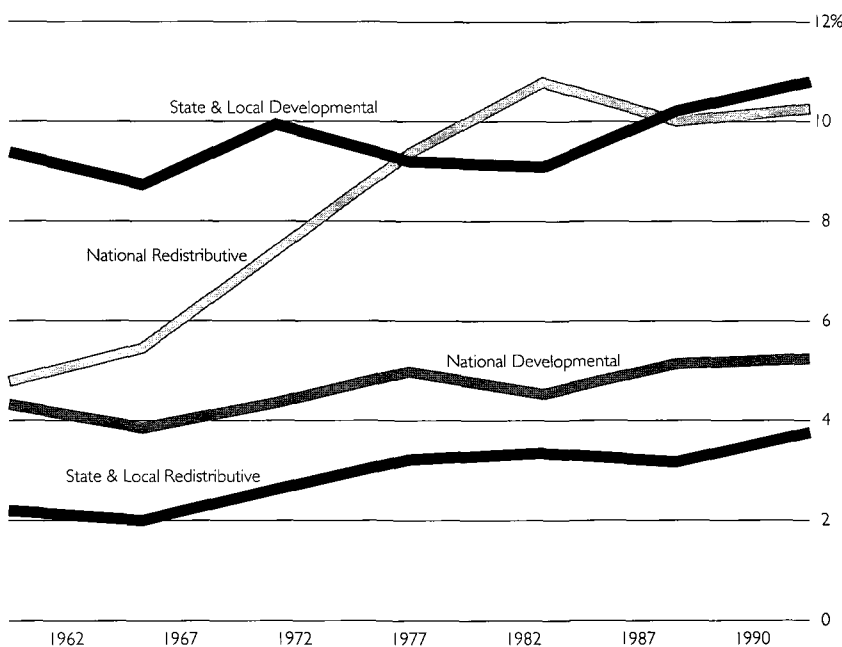
This kind of developmental pork prospered during the sixties and seventies partly because Congress was organized into subcommittees that focused member attention on narrow issues and interests. But it was also facilitated by the fact that the revenues of the national government increased automatically by means of inflation-induced bracket creep within a steeply progressive income tax. Members of Congress could enjoy increasing tax revenues without ever passing a tax increase. Indeed, it was possible to claim that taxes were being cut even when inflation was causing them to increase. (The famous Kennedy tax cut of 1963, for example, was in fact nothing other than an offset against bracket increase.)

But in 1981 income taxes were sharply reduced, brackets were indexed to inflation, and fiscal deficits mounted. In subsequent years, every new federal program had to be paid for with a new tax. Even existing programs were endangered by the squeeze created by the pressing demand for tax cuts and the rising cost of senior-citizen entitlements. Developmental pork lost its allure. The size of the intergovernmental grant program dropped precipitously, and the percentage of the remaining grants that were developmental (as distinct from redistributive) declined from a high of 59.5 in 1977 to 43.1 in 1990. Far from being a radical departure from past practice, the recent cuts in developmental spending proposed by both Republican leaders and the Clinton administration are just the latest in a decade-long series of like-minded decisions.

Not that Washington should play no role in economic development. Some policies, such as investment in scientific research, have such broad and far-reaching consequences that they must be carried out by the national government. Others, such as certain components of the communication and transportation system, must be coordinated in Washington to achieve a desired degree of national integration. Still other development aid to states and localities allows the national government to minimize the adverse effects of economic development on the environment.

Nevertheless, the national role in economic development has dwindled in recent years under the

Figure 1. Redistributive and Developmental Expenditure of National and of State & Local Governments as a Percentage of the Gross National Product, 1962–90.



pressure of fiscal deficits, anti-tax pressures, and senior-citizen entitlements, and it will probably continue to do so.

Redistributing the Wealth

For the same reason that local governments are best suited to providing economic development—the mobility of labor and capital—they are not effective at redistributing wealth. Local governments, for example, avoid progressive income taxes. No more than 3 percent of local revenues comes from this source. Any locality making a serious attempt to tax the rich and give to the poor will attract more poor citizens and drive away the rich. No amount of determination on the part of local political leaders can make redistributive efforts succeed. If no other force is able to stop their efforts, bankruptcy will.

The smaller the territorial reach of a local government, the less its capacity for redistribution. Most small suburbs in metropolitan areas have almost no capacity to meet the special needs of low-income citizens, because the effects of such actions would be immediately felt in the suburb's tax rate, property values, and attractiveness to business. Big cities are somewhat better able to undertake redistribution because of their greater geographical reach and their control over extremely valuable land at the heart of the nation's transportation system.

The greater territorial reach of states also makes them better at redistribution than most local governments. The costs of moving across state lines is more

substantial than changing residence within a metropolitan area. As against the 17 percent of the population who change residence every year, only 3 percent move across a state line. Even so, labor and capital can and do move, and states must take that possibility into account in their policymaking. Since 1970, for example, states have been in something of a race to lower welfare benefits for fear that high benefits could attract poor people to the state—thus raising social spending and perhaps triggering an exodus of taxpayers.

The bulk of the responsibility for income redistribution falls to the national government. It levies higher taxes on the well-to-do than on the poor, then carries out redistribution through pensions, welfare, health care, and other programs aimed at the needy, the old, the sick, the disabled, and the disadvantaged. The largest and most successful redistributive programs in the United States—Social Security and Medicare—are designed and administered in Washington. And again the explanation is capital and labor mobility—or rather comparative immobility. Washington is best suited to engage in redistribution because it can prevent the in-migration of labor from foreign countries and need not worry as much about the outward flow of capital. If any state or local government had attempted to mount programs like Social Security by itself, it would have gone bankrupt long before becoming a haven for the aged.

The increasing integration of the world economy has begun to erode some of the national government's redistributive capacities. Information and products can move globally at low cost. Capital also flows freely. Nevertheless, as long as the U.S. political economy remains healthy and stable, the national government will continue to have the capability of redistributing substantial amounts of the national income.

Current economic trends are having a considerably more powerful effect at state and local levels. The improvements in transportation and communication systems that have produced an increasingly integrated world economy are also at work among states and localities within the United States itself. Capital, entrepreneurial activity, and skilled labor have become ever more mobile. State and local governments now face increasingly competitive relationships with each other and must attend ever more strictly to economic development. The result is that they are growing ever more reluctant to provide for the needy within their ranks.

Making the Best of Federalism

The Republican proposals for wholesale policy shifts from Washington to the states and localities have grabbed their share of headlines, and many are likely to be signed, sealed, and delivered. Plans to transfer economic development functions to the states are not only politically feasible but also smart policy, for they place economic development in the hands of those policymakers best able to manage it.

But the Republican plans to move welfare policymaking to the nation's statehouses are more dubious,

if for no other reason than that state and local officials have become increasingly reluctant to pay for the cost of social policy. It is my (perhaps reckless) prediction that any policy enacted in the forthcoming Congress that dramatically shifts the responsibility for welfare downward to states and cities will prove unworkable and short-lived, simply because such shifts run at odds with the underlying structure of the federal system. If I am wrong and welfare policy is permanently turned over to the states, the well-being of the most marginal members of society, including large numbers of children living in poverty, will be adversely affected in serious ways.

States have demonstrated that they are increasingly incapable of sustaining welfare benefits in an ever more integrated economy. State AFDC benefits are jointly funded by the national and state governments but set at the state level. For the first 33 years after AFDC was established in 1937, states raised the real value of this benefit program steadily. The mean benefit paid to a family in the average state was \$287 in 1940, \$431 in 1950, \$520 in 1960, and \$608 in 1970 (all figures are in 1993 dollars).

But in 1970 welfare benefits began to decline, partly because states became more fearful that high benefit levels were attracting and retaining poor people within their states. In 1969 the Supreme Court decided, in *Shapiro v. Thompson*, that newcomers could not be denied access to state welfare benefits. Over the next 20 years evidence accumulated that high benefit levels acted as a (low-strength, but nonetheless detectable) welfare magnet. The debate over the welfare magnet intensified and, after 1970, welfare benefits began to fall—to \$497 in 1975, \$437 in 1980, \$409 in 1985. In 1990 they reached \$379, and in 1993 they dropped to \$349, not much more than they were in 1940!

In the earliest days of this century, states often led the way to innovative social policies (Wisconsin had an unemployment compensation system before the national government did). But in recent years state proposals to reform welfare have generally taken the form of reductions in welfare assistance. In 1988 the Family Support Act explicitly gave states the opportunity to experiment with Aid to Families with Dependent Children. The first three proposals submitted to the Department of Health and Human Services all proposed new restrictions on welfare. Wisconsin and New Jersey petitioned, among other things, to withhold the increase in benefits that typically comes with the birth of an additional child. California proposed an immediate 25 percent reduction in benefits, a second further reduction for all families remaining on welfare after six months, and a restriction that limited benefit levels to new arrivals to California to the level they were receiving in their previous state of residence. What began in a few states is now spreading nationwide.

Although AFDC has been the major target of state welfare cuts, other redistributive programs have proven to be politically unpalatable as well. State general assistance programs have all but disappeared. State supplementary benefits to the long-term unem-

ployed and to disabled persons have also been dramatically reduced, even while national benefits have kept pace with increases in the cost of living. State contributions to unemployment insurance programs have fallen far short of what is necessary to maintain their viability.

Looking to the Future

Intensified state and local opposition to redistribution is understandable in an economy that has become increasingly integrated and a society that has become ever more mobile. States and localities can no longer make policy choices as if they were living in isolation from other parts of the country. The decisions they take are noticed by people elsewhere, and the impact on their economic and fiscal situation will be felt sooner rather than later. One may regret that states and localities no longer seem capable of caring for their sick and needy, but it is a price a federal system must pay in an ever more integrated society.

Because states and localities are unequipped to finance social welfare programs, their role in any welfare reform should be carefully circumscribed. The legislation approved in March by the House Ways and Means Committee to abolish AFDC gives states far too much latitude to set policy and is almost certain to worsen the "welfare magnet" problem. As some states tighten eligibility standards and reduce benefit levels, states with more generous benefits will become more powerful welfare magnets than ever before and yet will receive no commensurate increase in federal funding, as now happens, if poor people move to take advantage of the more generous benefits. And states are already making strenuous efforts to avoid losing the "race to the bottom."

The state of Wisconsin reported last summer that about 20 percent of new AFDC applicants in Milwaukee county came from new residents, many of whom were arriving from Illinois, a state with lower welfare benefits. To respond to these pressures, Wisconsin asked the national government for permission to try an experiment in which recent migrants would for six months only receive a level of benefits equal to that of the state from which they were migrating. In the past, courts have declared such discriminatory treatment of newcomers as unconstitutional, but the Supreme Court announced last fall that it would be willing to revisit this issue. If discrimination against newcomers to a state is given constitutional blessing, a new round of state welfare cuts can be anticipated.

Time has shown that the national government has a different sphere of competence than that of state and local governments. The new breeze blowing through Washington should capitalize on this increasingly well-known fact and return to states and localities most of the responsibility for maintaining the nation's physical and social infrastructure necessary to sustain economic growth. But some things, namely programs for the sick, the poor, the needy, and the elderly, remain a Washington responsibility. To turn these responsibilities over to the states is to turn the clock backward. ■

TWO WHO TRIED TO BUCK THE TREND

One way to gauge the likelihood of Republican success in transferring economic development and redistributive policy to the states is by looking at the experience of two presidents who recently came to Washington intent on reversing the evolving trends in federalism—one to increase the state role in redistribution, the other to increase the national role in economic development.

In 1982 Ronald Reagan proposed handing over to the states complete fiscal responsibility for welfare policy (in exchange for national fiscal control over Medicaid policy). When that proposal failed to win either congressional or gubernatorial support, the administration issued a report in 1986 urging greater state control of welfare policy and arguing that "our centralized welfare system contributes significantly to the persistence of poverty in America." It specifically recommended legislation that would waive federal welfare rules to allow states and communities to experiment. But within two years, President Reagan signed a law—the Family Support Act of 1988—that, while allowing states to engage in some experimentation, actually strengthened Washington's control of the welfare system and imposed yet more federal requirements on states. It remains to be seen whether a conservative Republican Congress can achieve what a conservative Republican president could not.

Bill Clinton's 1992 presidential campaign stressed the need for the national government to promote U.S. economic development. Once in the White House, Clinton called for immediate passage of a \$19.5 billion stimulus package—chock full of job training, transportation, and other economic development programs—to get a floundering economy going again. He also sent Congress a long-term economic plan in which he proposed an additional \$160 billion in new spending over the next four years, much of it for transportation, including highway construction, mass transit, high-speed rail links, and improvements at aging airports.

When, shortly thereafter, data turned up to show that the economy had been growing at an astounding 4.2 percent rate during the fall of 1992, Senate Republicans killed the stimulus plan. And no sooner did Congress dismiss the stimulus package than it gutted half of the investment program in Clinton's main package as part of its effort to reduce the deficit. Just as Ronald Reagan was unable to shift redistributive tasks downward to states and localities, Bill Clinton was unable to force the national government to assume additional developmental responsibilities.

UNFUNDED MANDATES

Balancing State and National Needs

JAMES R.
ST. GEORGE



Among its first acts, the new 104th Congress passed legislation to limit unfunded mandates. The legislation curbs the federal government's power to require state and local governments to undertake major new programs without providing the funding for those programs. Under the new law Congress must either pay for any newly mandated programs—and identify a federal agency charged with reducing or eliminating the mandate requirements if Congress fails to provide full financing—or cast a separate vote indicating its intent to impose an unfunded mandate.

Origins of Consensus

The speed with which Congress acted on this issue suggests something approaching a national consensus that Washington has been imposing undue burdens on states and localities. Indeed, state and local officials—urban and rural, liberal and conservative, Republican and Democrat—appear to be largely of one mind in challenging the legitimacy of federal unfunded mandates. Even when these officials accept the intent of a particular federal mandate, they argue that Washington is wrong to substitute its priorities for local preferences. In a world of limited resources, they say, states and localities are increasingly unable to implement their own policies because of the burdens and requirements imposed by the federal government.

In requiring states and localities to spend their own resources to fulfill the mandate, federal officials are not subject to normal political constraints. They do not have to impose higher taxes or make difficult decisions about spending priorities to pay for the public services they mandate. The result may be an inefficient allocation of resources. The new mandate legislation, by requiring a separate vote on any new unfunded mandate, attempts to reassert those political constraints.

The congressional action explicitly signals voters regarding the level of government responsible for the taxes or spending choices required to finance unfunded mandates.

Consensus around unfunded mandates grew out of fiscal difficulties facing state and local officials in recent years. State and local policymakers confronted with budget deficits, spending cuts, and tax increases naturally began looking for the source of their troubles. They identified a range of potential causes, including the recent recession, the escalating costs of Medicaid and other health care programs, the public demand for new prisons, and unfunded federal mandates. Focusing on unfunded mandates had two advantages. First, it was a problem over which some measure of control was possible. Compared with stopping recessions or running counter to

the popular appetite for new prisons and longer sentences, limiting the ability of Congress to impose unfunded mandates would be easy. Second, a drive to stop unfunded mandates would dovetail with the nation's anti-Washington, anti-Congress political mood. Surely the public would be willing to blame Washington for the problems state and local officials faced.

While drawing the attention of Congress and the public to the fiscal impact of unfunded mandates has been a valuable contribution to sound public policy, the attack on unfunded mandates has obscured several important policy issues. First, imposing unfunded mandates is in many cases a legitimate assertion of national standards and may be the most efficient means of achieving them. Second, the federal government provides substantial financial assistance to states and localities for services, such as education and public safety, traditionally viewed as state and local responsibilities. Third, a major cause of fiscal stress for states and localities has been the failure of their revenue systems to keep pace with a changing economy. Finally, the constitutional amendment proposed by Republicans in Congress to require a balanced federal budget could dwarf the fiscal impact of unfunded mandates.

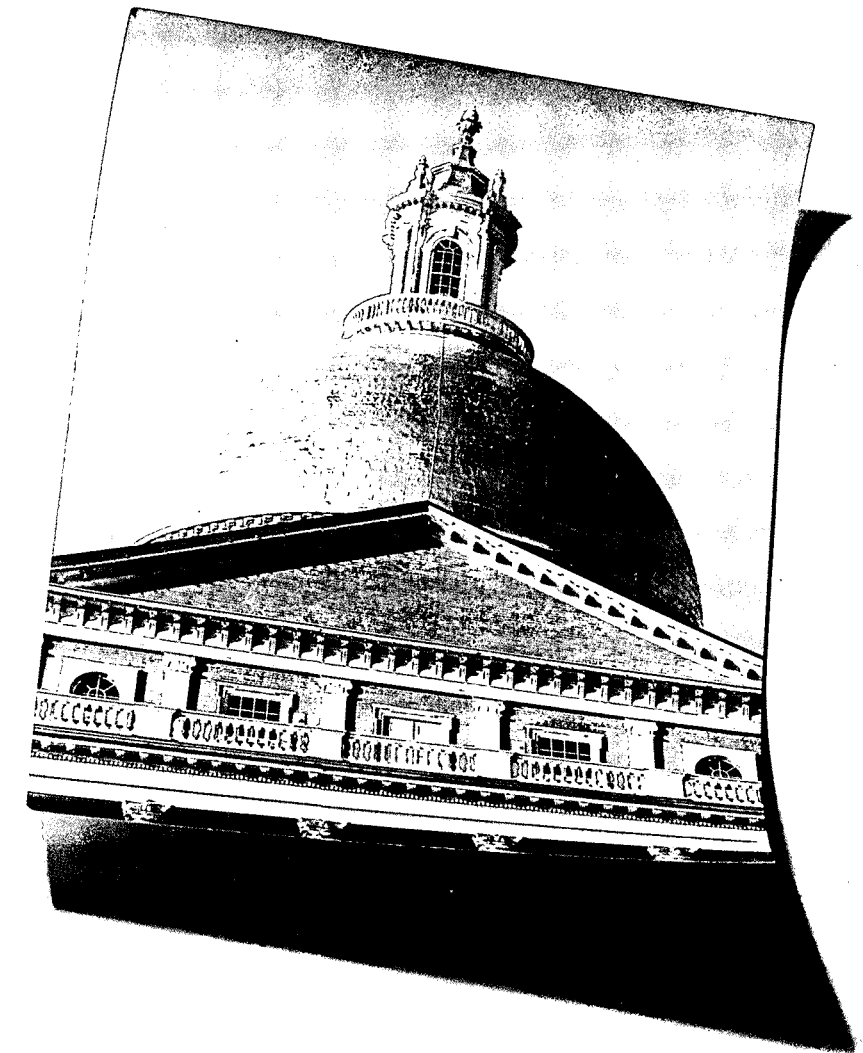
The Legitimacy of National Standards

In many cases it is entirely reasonable to establish national standards that everyone—including private employers, businesses, and states and localities—must observe. Like other employers, for instance, state and local governments must obey minimum wage, child labor, and civil rights laws. Not even the most ardent opponents of unfunded mandates have suggested that state and local governments should be exempt from these laws or that Washington should finance the cost of compliance.

The new unfunded mandate legislation recognizes the value of certain unfunded mandates by exempting federal laws that protect constitutional or civil rights. Even though the exemption applies to laws that were once extremely controversial—and were attacked for imposing federal rules over “states’ rights”—few today would dispute the federal government’s right to impose these obligations on state and local governments.

Similarly, it may be appropriate to establish national standards to meet a range of policy goals that could be described broadly as public goods, that is, goods like education or transportation that benefit the society or community at large rather than particular individuals. Because the benefits of public goods are available to individuals who do not pay for them, governments tax people to ensure that an optimal level of the good is produced. In a particular jurisdiction, however, voters and taxpayers may not tax themselves sufficiently to provide an adequate level of some public goods without federal intervention because they may not perceive themselves as reaping the full benefit of those goods. In these cases federal mandates may be the only method of allocating public goods efficiently.

It is well documented, for example, that providing preventive medical care and ensuring good nutrition for children are cost-effective investments. Children whose education suffers because they are chronically hungry or



sick are unlikely to become fully productive adults. Much of the cost of inadequate childhood health care or nutrition, however, must be paid years after the damage is done. And in an increasingly mobile society, the costs—unemployment benefits, welfare dependency, incarceration, medical treatment—might well be incurred outside the town or state where the child was reared. Thus, while it is in the public interest to ensure adequate health care and a healthy diet for every child, it may not be in the narrow self-interest of each community to invest the full resources necessary to do so. This is not to say that state or local officials are somehow indifferent to the needs of children in their community. It only suggests that to the extent that costs accrued and benefits received are part of the matrix of policymaking, the mobility of human capital implies that states and localities may provide a less than optimal investment in these public goods absent national standards.

Environmental protection is another area in which states and localities may not on their own allocate sufficient resources to public goods. Reducing pollution can be thought of as a public good, because dirty air and fouled water do not stop at municipal or state borders. Underground storage tanks can leak chemicals that contaminate drinking water in distant locales. Midwestern factories create acid rain that falls in New England lakes. While an industrial state may want to

James R. St. George is the acting director of the State Fiscal Project at the Center on Budget and Policy Priorities. He is the co-author of Holding the Bag: The Effect on State and Local Governments of the Emerging Fiscal Agenda in the 104th Congress (CBPP, 1995).

reduce the impact of pollution, it is unlikely to account fully for the damage done by its pollution in other states. Moreover, to the extent that states compete with each other for economic development opportunities, they have an incentive to reduce spending on programs without short-term, in-state benefits. Again, it may be that only national standards can ensure the appropriate and efficient level of these public goods.

It is argued that when national standards are appropriate, Congress should provide national funding. But it is not always efficient for Washington to finance its mandates; it may be important for the implementing level of government to have a stake in holding down costs. Without such an incentive, the federal costs of mandate legislation could grow beyond amounts necessary to achieve established goals because state and local governments could "game" the system to maximize their federal payments.

In recent years, for example, many states were so creative in taxing health care providers to increase their federal Medicaid reimbursements that Congress and the executive branch had to step in to restrict the use of provider taxes. In this case, the federal government was merely matching state expenditures; even so,

states found a way to leverage additional and in some cases unwarranted federal dollars. Such episodes should give pause to anyone who doubts that state or local officials would manipulate funding opportunities inappropriately.

The cost of funding federal mandates could also be driven up by perverse incentives states and localities would face under an unfunded mandate ban. The practical effect of prohibiting unfunded mandates would be to reimburse state and local governments for the cost of complying with any new mandate less any costs they were bearing before the mandate was imposed. The greatest subsidies would go to governments that had deferred action in the area in question. Timely state or local action to address an emerging problem, although perhaps more cost effective, would reduce the potential for subsequent federal reimbursement, presumably in perpetuity. Thus states and localities would be tempted to delay solving new problems if they saw a reasonable chance of federal action in the future.

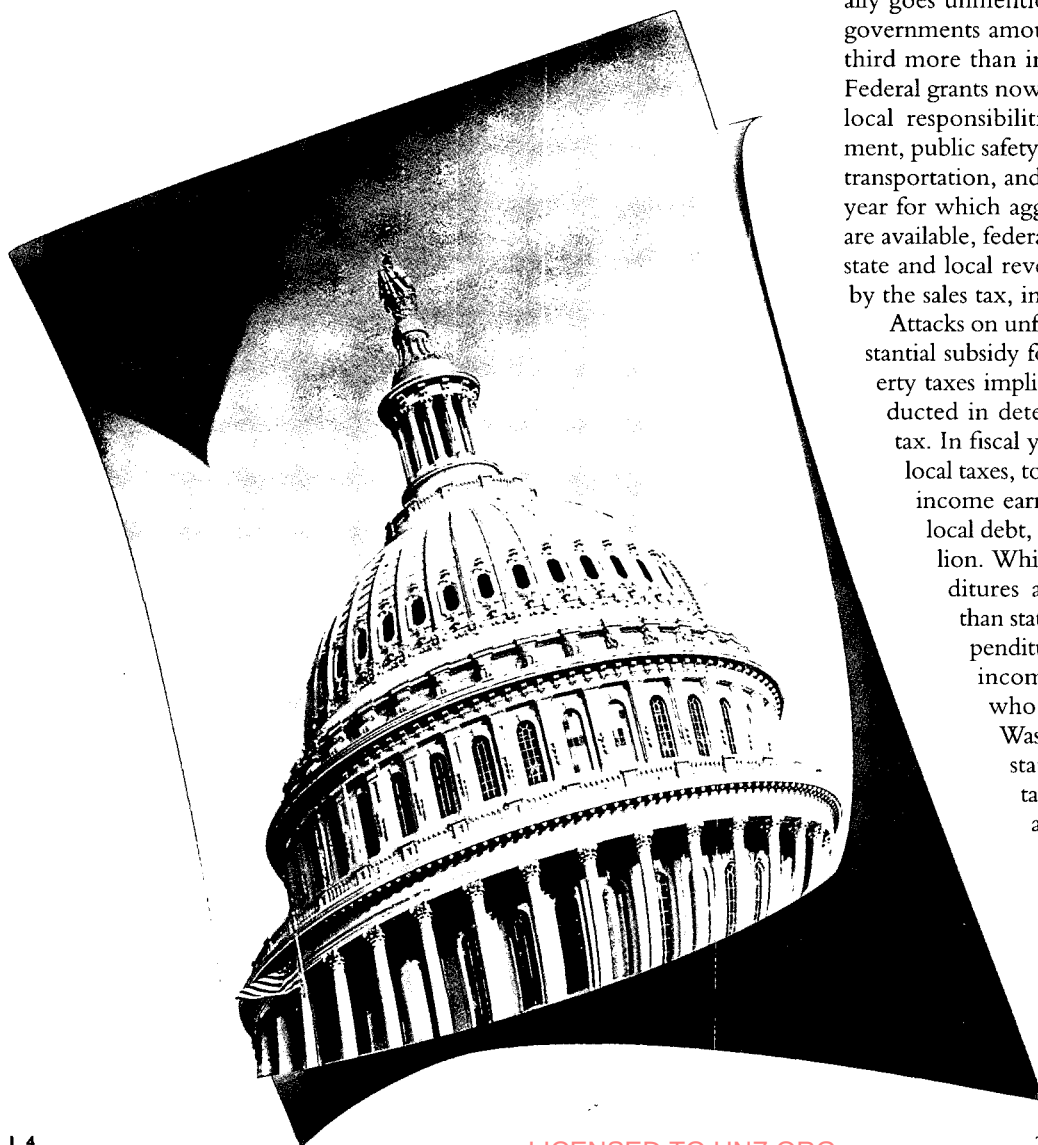
Federal Aid for States and Localities

In discussions of unfunded mandates and the costs they impose on states and localities, the considerable support Washington provides for state and local activities usually goes unmentioned. Federal aid to state and local governments amounted to \$217 billion in 1994, one-third more than in 1980 after adjusting for inflation. Federal grants now subsidize a broad range of state and local responsibilities, including economic development, public safety, job training, wastewater treatment, transportation, and education. In fact, in 1992, the last year for which aggregate state and local revenue data are available, federal aid was the largest single source of state and local revenue, exceeding revenue generated by the sales tax, income tax, or property tax.

Attacks on unfunded mandates also ignore the substantial subsidy for state and local income and property taxes implicit in allowing such taxes to be deducted in determining federal income subject to tax. In fiscal year 1994, the deduction of state and local taxes, together with the exclusion of interest income earned from various forms of state and local debt, cost the federal government \$66 billion. While the savings from these tax expenditures accrue directly to taxpayers rather than state and local governments, the tax expenditures reduce the cost of state and local income and property taxes for taxpayers who itemize on their federal returns.

Washington in effect pays 40 percent of state and local income and property taxes for the highest-income taxpayers and lower shares for other taxpayers. The protests from state and local officials that greet any proposal to eliminate these tax expenditures are ample evidence of their awareness of the subsidy the tax expenditures provide for state and local services.

Precise comparisons of the benefits of federal aid



and the cost of unfunded mandates are impossible because of a lack of good data on the cost of mandates. But the value of federal aid probably far exceeds the costs of unfunded mandates. In 1993 the U.S. Conference of Mayors estimated the cost of 10 of the largest and most prominent unfunded mandates in more than 300 cities at \$6.5 billion. Given that the population in these cities accounts for half the total population of all cities with at least 30,000 residents, as well as the possibility that the self-assessment of the burden was overstated, it is certainly possible that the total cost of unfunded mandates to municipalities is less than the benefit cities realized from tax expenditures alone.

Similarly, the Advisory Commission on Intergovernmental Relations has estimated that the cost of all unfunded mandates passed between 1983 and 1990 totaled between \$2.2 billion and \$3.6 billion in 1992. Even if these estimates are seriously understated, it seems unlikely that states and localities spend more on unfunded mandates than they receive in financial aid and tax subsidies from the federal government.

Outdated State Revenue Systems

The focus on unfunded mandates also obscures other causes of fiscal stress over which state and local officials themselves have some control. According to a report issued jointly by the National Governors' Association and the National Conference of State Legislatures, *Funding State Services in the 1990s*, one cause of states' fiscal problems is their failure to update their revenue systems to reflect the changing American economy. Outdated revenue systems lead to structural deficits that require state officials to increase tax rates or cut spending on a recurring basis. For example, consumers buy a far larger share of services relative to goods than they did 30 years ago. Yet state sales taxes typically apply only to certain services. One result—along with a potential tax advantage for service providers over goods producers—is that most states' sales taxes generate less revenue for each dollar of total consumption than they once did.

State revenue systems have also failed to keep up with the increasing prevalence of businesses operating across state borders. Tax codes largely constructed during the 1930s are poorly situated to collect taxes from complex interstate and international businesses. In addition, the growth of state tax expenditures—essentially, spending programs that operate automatically through the tax code—has drained state coffers while other spending needs go unmet. A recent report by the Center on Budget and Policy Priorities found that in 11 of the 15 states with data available for analysis, tax expenditures grew faster than on-budget spending between 1990 and 1992. Concentrating too narrowly on the problems caused by unfunded mandates may weaken the resolve of some state officials to try to update their own tax systems to reflect the modern global, service-oriented economy.

Impact of a Balanced Budget Amendment

The biggest threat to state and local governments, however, comes not from unfunded mandates or outdated revenue systems, but from proposals in Congress

to cut taxes and balance the federal budget by fiscal year 2002. Congressional leaders have indicated that they will exempt about half of the federal budget—Social Security, defense spending, and legally binding interest payments on the debt—from cuts, with the result that federal aid to states and localities would be extremely vulnerable to cuts. A report released in January by the Center on Budget and Policy Priorities, *Holding the Bag*, found that if across-the-board spending cuts are enacted in the unprotected half of the budget, federal aid to states and localities would be cut \$390 billion over the next seven years below the amount projected by the Congressional Budget Office under current law.

Congress is likely to begin efforts to eliminate the deficit immediately, subjecting states and localities to a loss in federal aid next year. If Congress follows a “glide path” of steady cuts over seven years, state and local governments could lose \$11 billion in federal aid in 1996. This modest down payment on eliminating the deficit—only the first of seven such cuts in subsequent years—is more than three times the high estimate of the cost in 1992 of all federal mandates imposed between 1983 and 1990. By 1998, less than halfway toward a balanced budget, state and local aid would be cut by \$37 billion—the equivalent of 12 percent of revenue from the state personal income tax, corporate income tax, and sales tax combined. According to these projections, unfunded mandates may be the least of worries for state and local officials in coming years.

A Delicate Balance

Unfunded federal mandates are, by any reasonable standards, a problem for state and local governments. New legislation limiting Congress's ability to impose future mandates and calling for a full accounting of the impact of already existing mandates is a reasonable compromise between the occasional need for national standards and the legitimate concerns of state and local officials. Federal officials, however, should not interpret the apparent consensus as meaning that unfunded mandates are somehow illegitimate. When the benefits of various spending programs accrue outside the borders of state or local jurisdictions, it may be necessary to require state and local officials to meet appropriate national standards. So long as federal officials are willing to acknowledge in a separate vote that they are imposing an unfunded mandate intentionally, the public will be able to judge the legitimacy of their actions.

At the same time, state and local officials should not focus so singlemindedly on eliminating unfunded mandates that they ignore fiscal problems that are within their purview to solve. State officials in particular should look carefully at the impact on their own budgets of eliminating the federal deficit while protecting half the federal budget before they ratify a balanced budget amendment. If Congress implements a plan to eliminate the deficit by 2002, state and local officials may discover that the loss of federal aid has shifted to states and localities a burden far greater than that of unfunded mandates. ■

In discussions of unfunded mandates, the considerable support that Washington provides for state and local activities usually goes unmentioned.



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ELECTRONIC REPRODUCTION PROHIBITED

In 1992 Chicago's Democratic Mayor Richard M. Daley was set to embark on a new economic plan for the city. At the heart of the plan was a third Chicago airport, to be built in the Lake Calumet area in the southern section of the city at an estimated cost of \$10.8 billion. Daley had already won the crucial agreement of Illinois's Republican Governor James Edgar for the project. Although the airport required little direct state money, legislative approval was nonetheless required to begin site development, and Daley made clear that the project was his primary legislative goal for the year. But the Illinois legislature refused to support the initial steps toward development, and Daley was forced to pull the project from consideration.

For Daley's father, longtime Chicago Mayor Richard J. Daley, such a setback would have been unlikely. Once he and a Republican governor had exchanged handshakes on a deal—typically, the governor offered support for economic development projects in the city, the mayor support for the governor's budget—the deal was done. All that remained to secure the interests of the city and those of rural “downstate” Illinois as well was for the legislature to offer its ritual blessing. It was a classic example of “logrolling”—the venerable American custom of neighbors helping each other roll logs into a pile for burning.

Since the senior Daley's death in 1976, state politics in Illinois—and around the nation—has been transformed. Older alliances in state politics started to crack when the nation's suburbs began outgrowing their cities during the late 1960s. But the explanation for the Illinois state legislature's veto of the airport project does not lie simply in the growth of America's suburbs. Complex changes in state and local political organization over the past 20 years have not only reduced urban power, they have also stymied the emergence of alternative coalitions essential for building a new metropolitan agenda.

Although Washington is currently abuzz with enthusiasm for handing over broad domestic policy responsibilities to the states, state governments—praised these days for their innovation, creativity, modernization, and enhanced capabilities—have shown little in-

MARGARET WEIR

Margaret Weir is a senior fellow in the Brookings Governmental Studies program. She is completing work on Race and Poverty in the City: Beyond Urban Isolation. This article is adapted from a paper prepared for a Department of Housing and Urban Development Roundtable on Regionalism.

terest in tackling the problems of cities. Instead, many of these “laboratories of democracy” now seem determined to evade the costs and responsibilities of urban problems by pushing both down to local governments that are often incapable of meeting either. Despite the recent outcry against unfunded mandates, cities are in danger of being handed the steepest mandate of all: to cope with concentrations of deep poverty relying on a depleted economic base made ever more vulnerable by business and middle-class flight to less-burdened suburban jurisdictions.

Newly Professionalized State Legislature

In 1962 the U.S. Supreme Court, intent on breaking the rural lock on state legislatures, ruled that states must reapportion their legislatures to grant “one person one vote.” That ruling, designed to benefit cities, set in motion reforms that modernized and “professionalized” many state legislatures and that, ironically, cut cities off from their longtime allies.

During the 1960s and 1970s, state legislatures, long derided as sleepy political backwaters, woke up to the 20th century. Many legislatures, most of which had once met part-time, began meeting virtually year round. Higher salaries for legislators transformed what had been an avocation into a career. Increased staff enabled legislators to engage in more informed policymaking.

The newly professionalized legislatures attracted money and interest groups. In Illinois, the number of lobbying organizations grew from 390 in 1982 to 998 in 1992. In New York state, interest group spending nearly tripled, mounting from \$9.2 million to \$26 million in those same 10 years.

Increasingly, interest groups began driving the legislative agenda. One Illinois lawmaker who took office in 1992 recalled being warned during his freshman orientation that while in the legislature, he would probably draft only four bills of his own. “The rest would be handed to me by special interests.”

The prevalence of interest groups has made simple logrolling across regions more difficult than in the past. In the absence of stable coalitions such as those once put together in Illinois by the Democratic mayor and the Republican governor, assembling legislative ma-

IN THE SHADOWS

CENTRAL CITIES' LOSS OF POWER IN STATE POLITICS

majorities is far more difficult and always requires more payoffs to more legislators. "Build Illinois," for example, launched in 1985 as a major state economic development program, quickly degenerated, according to Charles Orlebecke, into a "slush fund for random projects identified through legislative trading."

Another innovation was the legislative caucus, organized by legislative leaders to provide funds and campaign assistance to legislative candidates. In Illinois during the 1990 elections, for example, legislative party caucuses spent \$4.9 million on state legislative elections, nearly 39 percent of the total. These legislative caucuses have concentrated power in the hands of the legislative leaders who control vital electoral and legislative resources. In Illinois, legislative decisionmaking often comes down to last-minute agreements between the governor and "the Four Tops," as the leaders of the two parties in the two chambers are called.

The power of legislative leaders has also reduced the scope for cross-party and cross-region political compromise. For one thing, legislative leaders are not independent of interest groups. They must remain attentive to the wishes of key interest groups since their power ultimately depends on the funds supplied by those groups. For another, the power of legislative leaders makes it harder for individual lawmakers to explore possibilities for common ground within the legislature because it bars them from making deals with members of opposing parties. According to one Chicago Democratic state senator, "lockstep voting" by Republicans has made it difficult to build on areas of common concern with some suburban Republicans.

Governors and the Politics of Regional Alliances

Because governors must win statewide elections, they have stronger incentives than do state legislators to build links among diverging state interests. Over the past two decades governors have gained authority and respect as their formal powers have increased and the analytic and administrative capacities of their office have grown. But newfound powers and competence have not equipped them to counter the increasingly entrenched and narrow interests in the legislature. And the new political geography of growing suburban strength and declining urban power has made even sympathetic governors ambivalent about championing city interests in ways that are costly to the suburbs or to the state itself. In these circumstances, governors may simply seek to reduce expectations on state government.

It is still possible for governors to push legislatures to move beyond narrow interests. They can promote broader thinking by facilitating bipartisan consideration of problems outside the immediate legislative setting. One Chicago state senator praised former Illinois Republican governor Jim Thompson (1976–90) for forming bipartisan councils to consider a range of state policy problems. These forums created, in the senator's words, "an overlay that forced things upward rather than being mired downward," thus encouraging legislators to look for broader solutions rather than forcing them into the most narrow interpretation of their interests.

During the 1980s some governors did use executive initiative to launch innovative policies in the areas of economic development, job training, education, and housing. In his 1988 book *Laboratories of Democracy*, David Osborne celebrated the accomplish-

ments of governors from both parties, including Richard Thornburgh (R-PA), Jim Blanchard (D-MI), and Bruce Babbitt (D-AZ), who forged an activist role for state government when the federal government was reducing assistance to local governments.

Yet none of the governors that Osborne praised holds office today. In many states they have been replaced by governors whose main appeal has been a promise to reduce state taxes.

Weakening Ties between States and Localities

Political parties were once the big city's lifeline to state politics. State political power flowed from the bottom up. Urban political machines linked politics across levels of government, and the stronger organizational power of cities allowed them to win benefits in state politics. Today, however, the power of political parties has waned dramatically, that of special interests has grown, and state politics is increasingly driven by considerations removed from localities. The city is but one supplicant competing with many others to influence policy.

In a recent survey, for example, New York state legislators ranked interests competing for their support into two tiers. In

the top tier were municipal employee unions and business interests. In the second tier, local governments, including that of New York City, ranked fourth behind the Teamsters, public utilities, and the New York State Catholic Conference.

Since the 1960s, municipal employee unions have won in Albany what they could not win in New York City. Although mayors of New York since Wagner have complained about having to foot the bill for pension levels they oppose, the money and potential electoral manpower controlled by municipal employee unions have made them hard to beat in Albany.

In Illinois, where state government intervenes less in the affairs of localities than it does in New York, the greater presence of interest groups has harmed the city less, but it has diverted the state agenda away from issues of concern to Chicago.

Once, big-city mayors could heavily influence if not dominate the city delegation in the state legislature. But as legislative leaders have developed independent resource bases, they have become more independent of mayors. They have also developed separate institutional interests that do not always coincide with those of the city.

The loss of mayoral power has been especially striking in the case of Chicago. In 1991 open conflict between Mayor Richard M. Daley and Democratic House Speaker Michael J. Madigan erupted when Madigan publicly accused Daley of intervening during a legislative impasse and making "secret deals" with Republicans—"deals" that were, of course, at the heart of legislative politics before the 1980s. In the 1992 airport dustup Madigan also demonstrated his independence, promising to deliver only a limited number of Democratic votes. The speaker viewed other priorities, including the state budget, as more important for the reelection prospects of House Democrats. But perhaps the strongest departure from the past is the relative disengagement of the second Mayor Daley from state Democratic politics and from the legislature. The mayor rarely visits Springfield, and Democratic legislators complain that the city does not strongly lobby for its interests in the legislature.

These developments have been particularly detrimental for the

CITIES CANNOT UNTANGLE THE PROBLEMS OF ECONOMIC DECLINE AND SOCIAL BREAKDOWN ON THEIR OWN.

urban poor. Although a mayor's interest in securing resources for the poor depends on his or her electoral coalition, mayors do have an inherent interest in reducing the cost of the poor to the city. Thus, although the first Mayor Daley was never a strong proponent of the poor, he repeatedly sought to push the costs of public assistance up to a broader financial base. He also sought to avoid being saddled with AFDC expenses when the state funds ran out in the early 1960s. By contrast, Democrats in the legislature, anxious to win suburban votes, now agree to push such costs back down to the city. In 1992 Speaker Madigan embraced fiscal austerity and distanced the party from programs for the poor. Shortly thereafter Illinois eliminated its General Assistance program and replaced it with a much smaller, poorly funded Earnfare program, a cutback that particularly hurt Chicago, where nearly 80 percent of Illinois recipients of General Assistance lived in 1992.

The Suburbs Are Feeling the Pinch Too

As state politics has become more disconnected from local government, the impact has been felt not only by cities but by suburbs as well. The problems are particularly acute in poorer suburbs, which have a much smaller tax base than the city but a high proportion of needy residents. Wealthier suburbs are less dependent on state aid but even there, splits are evident among local officials, who must provide services, and state legislators, who have made their opposition to taxes a central political tenet.

These tensions among state and local politicians are evident in the suburban counties surrounding Chicago. Suburban legislative leaders have opposed efforts to increase the state income tax to reduce the heavy reliance on property taxes in Illinois. Instead, they have imposed property tax caps on the "collar" counties and have sought to extend the tax caps to the rest of the state.

The caps, which limit the increase in property tax to 5 percent or the rate of inflation, whichever is less, have strained the counties' ability to deliver services and have particularly hurt fast-growing suburbs with rising school-age populations. The sense that state legislators have represented only a narrow part of suburban interests prompted the creation of the Suburban Mayors Action Coalition, a group that includes 110 suburban Cook County mayors. Opposition to tax caps has been one of the group's central issues. More generally, the group seeks to present a more liberal view of suburban interests than do most suburban state legislators.

The burdens that state governments place on local governments, both through their attentiveness to other interests and through their efforts to cut taxes, will likely stimulate political divisions among suburbs and raise possibilities for occasional coalitions between some suburbs and cities on state legislation. But the strength of the anti-tax sentiment in suburbs and an often well-founded mistrust between city and suburban leaders make the task very difficult.

Looking Ahead

The trends affecting cities in state politics are both demographic and political. The decline of the city population, the rise of the suburbs, and the increasing power and fragmentation of state leg-

islatures have all disrupted an older pattern of policymaking based on logrolling across regions. And the growing disconnection between state and local politics has encouraged state politicians to enact policies with little regard for their effects on localities. Although this article has focused on Illinois and to a lesser extent on New York, similar trends can be seen in other states with big cities. In Texas, for example, the rise of suburban power in the state legislature has made annexation increasingly difficult and thus afflicted Houston with higher levels of poverty, white flight, and strained city resources. California has gone even further through the use of the initiative process. Since 1978 state and local spending has been limited in ways that both push costs down to counties and municipalities and restrict the revenue-raising capacity of local entities.

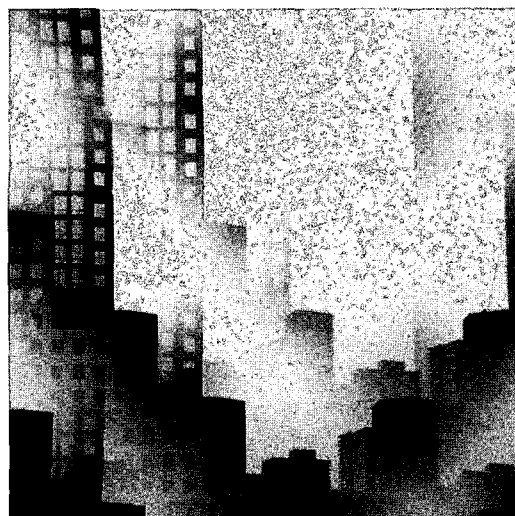
Given the political changes in states during the past three decades, cities, as governmental entities, are unlikely to win substantial new benefits from higher levels of government. Politically, three kinds of strategies offer the best hope for cities in the future. First, mayors must seek to engage surrounding communities in alliances to share costs or push them upward wherever

possible. It is unlikely that alliances will be global, but possibilities exist for cooperation across political boundaries on some issues, which may differ from state to state. Second, mayors must be willing to engage in trade-offs that benefit the urban poor even if they do not benefit the city per se. Thus, city support for economic development projects outside the city could be traded for guaranteed jobs for city residents on those projects. Mayors have not often taken this broader view of their role, preferring to spend political capital only for projects within their boundaries. With the burden of non-working residents weighing so heavily on cities, however, mayors have much to gain by engaging in political compromises that help poor city residents,

even if they don't help the city itself.

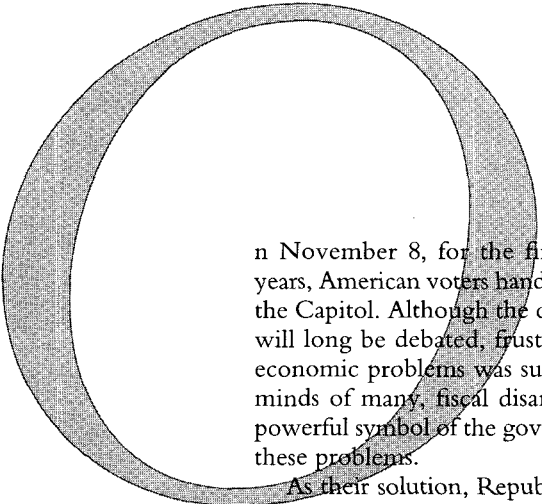
Third, although it has become politically difficult to assist cities as governmental entities, it may be more feasible to assist community groups. The new emphasis on empowerment by conservatives does not include much in the way of resources, but the logic of the strategy may create some openings for assisting community organizations, especially through indirect mechanisms such as tax breaks for business. The biggest challenge, however, is to overcome the isolation of the urban poor by building ongoing connections between poor communities and the suburban nodes of growth and prosperity. Unless these connections are made, it will be difficult to sustain the gains of community action.

In the end, however, these efforts are but palliatives. Poor communities and cities cannot untangle the problems of economic decline and social breakdown on their own. Unless states use their substantial authority over land use, taxation, and education to discourage urban flight, spread the financial burden of poverty more fairly throughout the state, and prepare the next generation of urban workers for high-skill jobs, the fiscal and social burden of cities will only worsen. The odds aren't good. Policymakers in Washington should think twice before handing this political hot potato over to the states. ■



What's in Store?

DANIEL E. SICHEL



n November 8, for the first time in more than 40 years, American voters handed Republicans the keys to the Capitol. Although the causes of this dramatic shift will long be debated, frustration over long-standing economic problems was surely a key element. In the minds of many, fiscal disarray in Washington was a powerful symbol of the government's inability to solve these problems.

As their solution, Republicans offered voters a 10-point "Contract with America." And since the election they have quickly gone to work on the contract, important parts of which focus on how the government conducts its business: how it taxes, how it spends, and how it operates. In particular, the contract calls for tax cuts, deep spending cuts except for defense and Social Security, and a balanced budget by 2002.

Although the balanced budget amendment in the contract floundered and was defeated in the Senate over the issue of how to treat Social Security, the fiscal promises in the contract are likely to set the political agenda for some time to come. Senate Majority Leader Robert Dole has vowed to bring the balanced budget amendment up again later this year, and pressure to reduce the deficit is unlikely to diminish. Moreover, the balanced budget amendment was just a promise to balance the budget. Congress can still pursue a fiscal path leading to budget balance by 2002, even without a constitutional amendment in force.

Thus, the fiscal promises in the contract are still front and center. And the key question remains: what must happen between now and 2002 to balance the budget and fulfill the other fiscal promises in the contract? But before looking ahead, it is helpful to look back a bit.

How Did We Get into the Deficit Mess?

Large budget deficits in peacetime are a relatively new feature on the U.S. economic landscape. By and large, deficits were small before the 1980s, except during wars and recessions. But in the early 1980s, the nation spun the fiscal roulette wheel: taxes were cut and defense spending raised without substantial spending cuts in other areas. At the time, the hope was that these changes would not boost the deficit because tax cuts

would actually boost revenues. But the nation lost that fiscal gamble, and the government's budget deficit soared. As each year's hefty deficit was added on to those of past years, the total debt of the federal government surged upward as well.

Figure 1 shows the ratio of total federal debt to gross domestic product (GDP) since the end of World War II. Following heavy wartime deficit spending, the ratio fell rapidly through the early 1970s and was roughly stable over the next decade. If the diagram ended in 1980, one would not conclude that the federal household was mismanaged. On the contrary, the record until then showed that small deficits and robust economic growth had combined to cause the debt to shrink as a share of GDP. This point bears emphasis. The deficit problem is not age-old. It was created by the policy mistakes of the early 1980s. At that time, large budget deficits pushed the total stock of debt up much faster than the economy, and the ratio turned back up, reaching 70 percent by 1995.

Recent years have seen some progress on reducing the deficit and therefore slowing the rate at which total debt is growing. The deficit reduction agreements of 1990 and 1993 helped bring a 1992 deficit of \$290 billion down to an estimated \$176 billion by 1995. But the Congressional Budget Office (CBO) now projects that the deficit will rise to \$320 billion by 2002, the year the contract promises a balanced budget.

Large deficits do not cause immediate harm to the economy. Rather, they eat away at its foundations. Saving and investment are key to future economic growth. Given the already low private saving rate in the United States, large deficits—or dissaving by the government—leave even less saving for other productive investments. Over extended periods, reduced investment implies less capital per worker and the gradual buildup of losses in labor productivity and wages. Of course, investments in the United States can be financed by borrowing overseas, but if foreigners help foot the bill—as they did during the 1980s—then they receive many of the benefits. Most economists agree that getting the deficit down would significantly improve the nation's long-run economic health.

The GOP Contract for Tax Cuts and a Balanced Budget

How Does the Contract with America Address These Problems?

Let us assume that the fiscal promises contained in the Republican "Contract with America" are put into action. The budget is set on a path to balance by 2002, which of course can be done even without a balanced budget amendment. Taxes are cut. As pledged, Social Security is not touched. Given the overwhelming anti-tax sentiment expressed in the last election, Republicans in Congress seem committed to eliminating the budget deficit through spending cuts. Now we look ahead to 2002 to see how these pieces fit together.

As indicated earlier, the Congressional Budget Office projects a deficit of \$320 billion in 2002 under current law. The pledge to balance the budget would bring that figure down to zero, implying a spending cut of \$320 billion. But the actual task is much tougher because the contract also promises a tax cut.

In particular, the contract promises a lower capital gains tax, a \$500 per child tax credit, more

Daniel E. Sichel is a research associate in the Brookings Economic Studies program. He is completing a book on the effect of computers on U.S. business productivity.

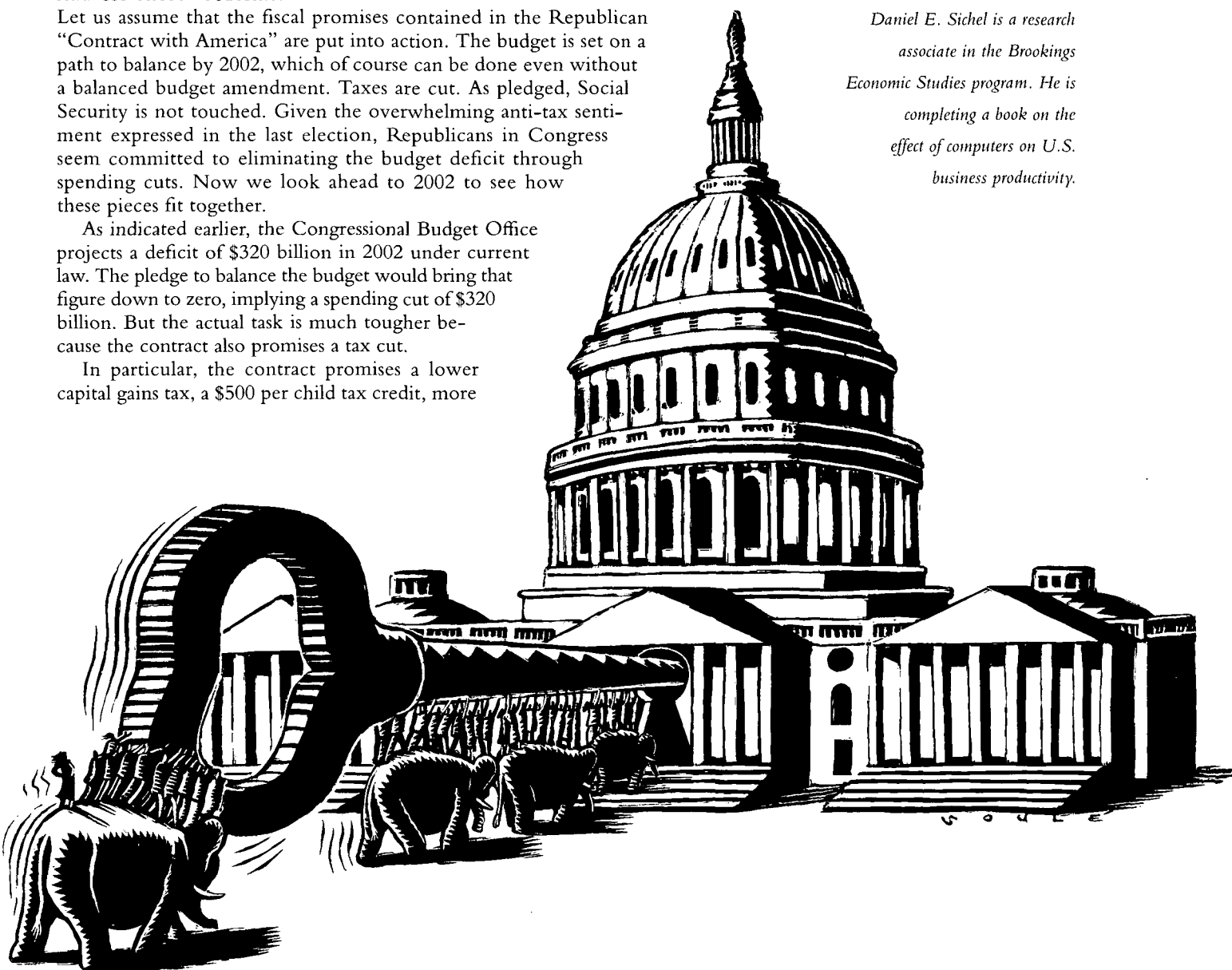


Figure 1. Federal Debt As a Share of GDP

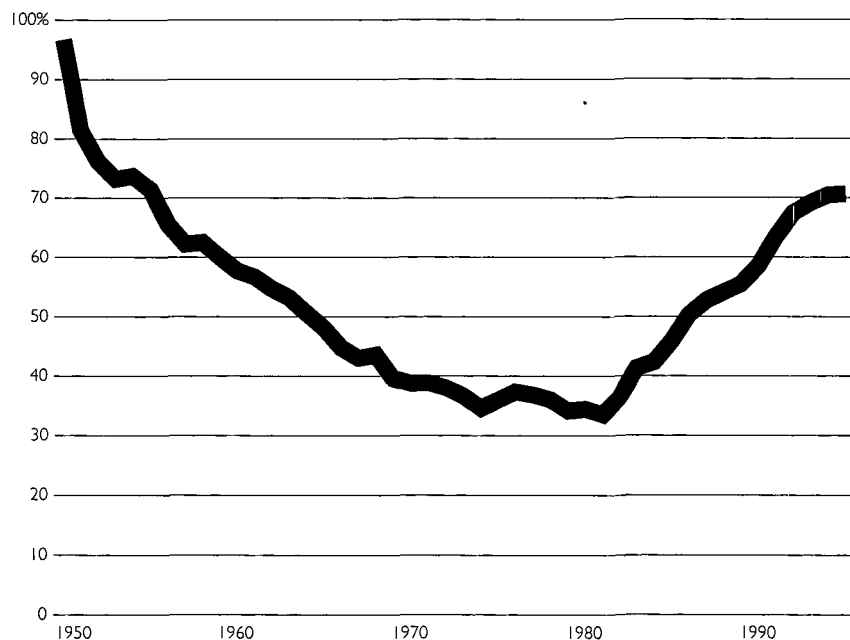
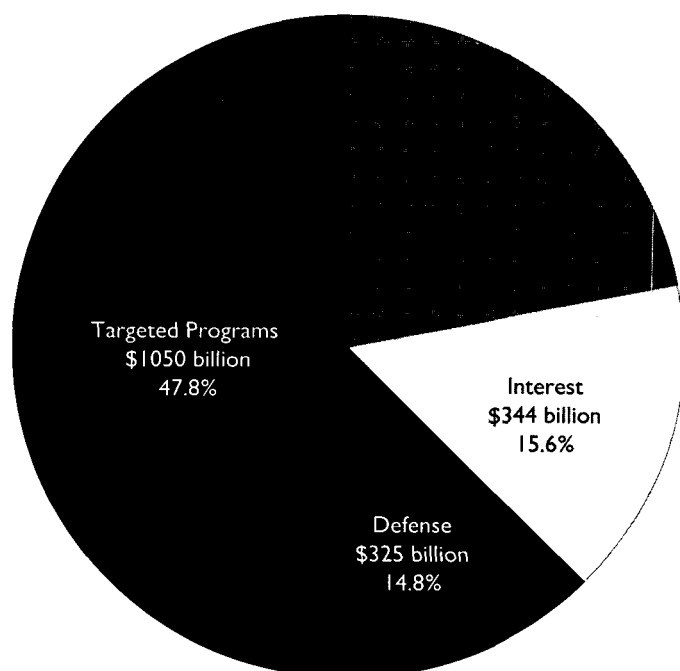


Figure 2. Projected Spending Shares, 2002



generous depreciation rules for businesses, and a cut in taxes paid by Social Security recipients. For this budget exercise, we will assume that all those tax provisions are enacted. Last December, the U.S. Treasury estimated that the cost of those tax cuts would average \$40 billion a year over the first five years, surging to more than \$100 billion a year for the next five. In 2002, the estimated revenue loss equals \$100 billion. The tax cuts make balancing the budget in 2002 even harder, because \$100 billion of spending must be cut just to stay even.

Thus, balancing the budget while paying for very expensive tax cuts means that \$420 billion must be cut from projected spending in 2002. If the budget cutters set to work at once, rather than waiting until 2002, the debt on which interest must be paid would be lower over the next seven years and interest rates might be lower too, possibly saving as much as \$100 billion in interest payments by 2002. Thus, the Republicans must find roughly \$320 billion in annual programmatic cuts in 2002. (In subsequent years, the challenge is even more difficult for two reasons. First, CBO projects that under current law the deficit will rise even further by 2005, pushed up by rising health care costs. Second, the revenue loss from the tax cuts in the contract explodes in later years.)

Such a cut would be difficult enough if it came out of all programs. However, the contract shields Social Security and defense from the budget knife. Figure 2 highlights the significance of this exclusion, showing CBO's projected spending shares for 2002 under current law. Social Security, defense, and interest payments on the debt account for more than half of all federal outlays, a crucial but often overlooked point. Because the contract promises to exclude these programs, the entire \$320 billion cut in programs must come from the much diminished "targeted spending" category, implying a reduction of more than 30 percent.

Table 1 emphasizes the ramifications of placing a big chunk of spending off limits for cuts. The top line shows projected spending in 2002 for all programs except interest and shows the spending cut of \$320 billion required to balance the budget under the promises of the contract. As the table shows, the excluded programs—Social Security and defense—are not to be touched, and therefore the targeted programs must be cut by almost one-third.

Within the targeted programs, the ultimate distribution of hits remains to be determined. Nevertheless, an examination of the components of the targeted spending category reveals who stands to lose under the contract, and who, therefore, might be expected to oppose the budget cuts. As the table shows, grants to cities and states account for about a quarter of the targeted spending category. These grants cover highway construction, support for education, health programs including Medicaid, disaster relief, and a host of other activities.

According to a recent Treasury Department study, some large states could be big losers if Social Security and defense are exempt from cuts and all programs in "targeted spending" are cut by nearly a third. For example, California—whose Republican governor Pete Wilson has been mentioned as a presidential hopeful—stands to lose as much as \$10.5 billion by 2002.

New York, whose newly elected Republican governor George Pataki has promised a large tax cut, would lose a similar amount; making up this lost revenue would require a state tax hike of more than 20 percent or substantial cuts in services. Governors and mayors may not go to the chopping block quietly.

Retirees also receive a big chunk of targeted spending, with Medicare and pensions (civilian and military) accounting for about 40 percent of the targeted category. Because retirees are a powerful political constituency, their programs may be spared the full force of the budget ax, but then, of course, the cuts in other programs would have to be that much greater.

Everything else in targeted spending is projected to cost \$350 billion under current law. If painful choices elsewhere make this category the chief target of the budget cutters, spending would be virtually eliminated for such programs as federal prisons, the federal court system, the National Weather Service, NASA, cancer research, the National Parks, and most other federal government activities.

Figure 3 provides another perspective on the challenge facing budget cutters, highlighting the source of pressure on federal spending. This figure charts shares of federal spending back to 1965, broken down a little differently than in the pie charts. Social Security, defense, and interest payments have accounted for more than half of federal outlays for many years. The share of spending for Medicare and Medicaid has risen rapidly since 1970, pushed up, in large part, by the steep ascent in health care costs, which has also affected the private sector. Unless a way is found to limit price increases for health care, either recipients of government health care must pay more, access to government-financed care must be limited, or health care costs will continue to put pressure on the budget. The category of spending labeled “other”—outlays less Social Security, defense, interest, Medicare, and Medicaid—has actually been on a downtrend as a share of output since around 1980, a fact that may come as a surprise to those subjected to the drumbeat of rhetoric about government programs eating up more and more of the economy’s resources.

Other Roads to a Balanced Budget

According to this budget arithmetic, it will be next to impossible to balance the budget if Social Security and defense are exempt from cuts and future tax hikes are ruled out. Some contend, however, that traditional budget arithmetic is the wrong way to frame the issue. Either they argue that the use of baseline spending assumptions makes budget balance look harder to achieve than it really is. Or they contend that this budget arithmetic implicitly—and wrongly—assumes a continuation of the current structure of federal spending. Does either critique offer an alternative road to budget balance?

Holding the Line on Current Spending

In the budget analysis summarized in the pie and bar charts, necessary spending cuts are calculated relative to a baseline budget, which itself is growing over time to take account of increases in population and

inflation. Critics argue that if spending could just be frozen at current levels, then the budget would be in balance by the end of the century. This line of reasoning is correct in principle, but difficult in practice because most of the projected increases in spending are for interest payments on the debt and entitlements that will be politically painful to cut.

For example, spending for Social Security is projected to rise about 5 percent a year in nominal terms because the number of retirees increases and because benefits are indexed to inflation. If spending on Social Security were frozen at 1995 levels, benefits in 2002 would be more than 30 percent lower than they would be if every recipient received the benefit promised under current law. Even if Social Security were allowed to increase at 3 percent a year to cover inflation, benefits in 2002 would still be 14 percent below what current law promises.

Similarly, outlays for Medicare are expected to increase more than 10 percent a year. Just as for Social Security, the number of retirees on Medicare is expanding. And rapid increases in the price of medical care, accompanied by ever wider use of new technologies, push up anticipated spending quite rapidly. Even if increases in Medicare outlays were held to only 3 percent, benefits in 2002 would have to be cut by more than a third relative to what recipients would receive under current law. Medical services received by retirees would necessarily be cut back.

Simple formulas for achieving budget balance—such as holding current spending constant—entail extremely hard political choices.

Taking a Chain Saw to Federal Spending

The other frequent criticism of conventional budget analysis is that trimming around the edges of the current structure of federal spending will never work; solving the deficit problem requires taking a chain saw to entire programs. Consider estimated savings from the following list of programs sometimes mentioned as candidates for cuts.

Completely eliminating federal payments for Aid to Families with Dependent Children—the government’s main welfare program providing cash benefits for the poor—would save an estimated \$16.4 billion a year by the end of the decade. Zeroing out farm subsidy programs would save \$10.8 billion a year. Stopping subsidies for urban mass transit would hold down yearly spending by \$4.8 billion. Defunding the space station would save another \$2.4 billion. Shutting down the Small Business Administration would save \$550 million (yes, less than \$1 billion). Eliminating federal support of Amtrak would save another \$800 million or so. Switching off the subsidies received by the Rural Electrification Administration would keep spending down by another \$90 million. At this point, a lot of political blood would have been spilled and the deficit would be down by only \$36 billion, a long way from the hundreds of billions in spending cuts needed to balance the budget.

Should spending be carefully examined to eliminate fat? Yes. Will that balance the budget? No. The lesson of budget arithmetic is simple. Although spending can

Figure 3. Federal Spending as a Share of GDP

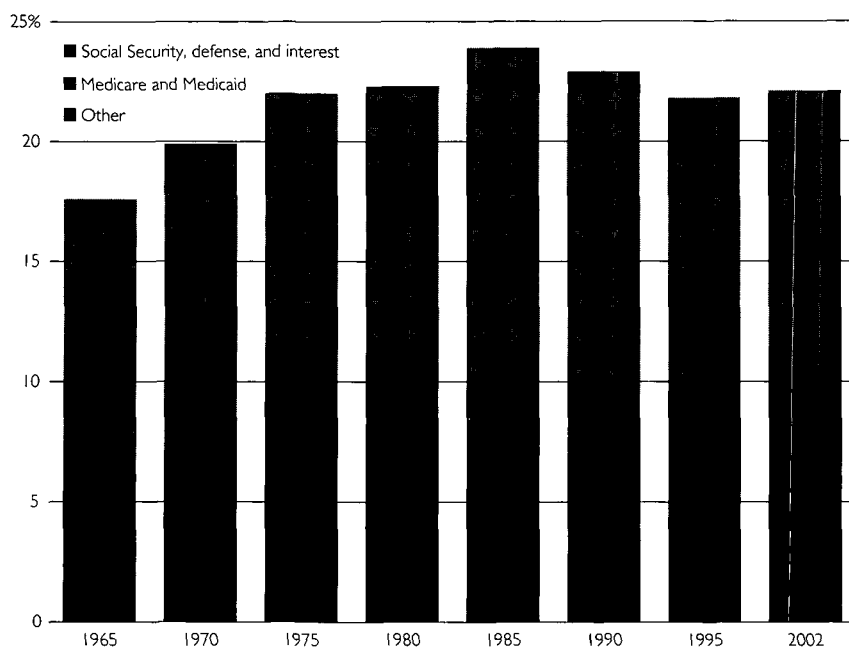


Table 1. Required Spending Cuts in 2002 under the Contract

(billions of dollars, except where noted)

	CBO PROJECTIONS UNDER CURRENT LAW	CUT REQUIRED UNDER CONTRACT	PERCENT CUT REQUIRED UNDER CONTRACT
Spending for programs (excluding interest)	\$1856	\$320	—
Excluded programs	806	0	0%
Social Security	481	0	0%
Defense	325	0	0%
Targeted programs	1050	320	30%
Cities and states*	265	?	?
Retirees†	435	?	?
Everything else	350	?	?

Source: CBO, Treasury, and author's calculations.

* Medicaid and other grants.

† Medicare, civilian, and military pensions.

be cut and efficiency improved in many areas, balancing the budget will be virtually impossible without touching the big programs like Social Security, Medicare, and defense. Back in the 1930s Willie Sutton explained that he robbed banks because that's where the money is. If Willie were a member of the House or Senate Budget Committee today, he would be looking up addresses for these large programs.

What Happens Once the Budget Is Balanced?

The difficulty of balancing the budget, of course, is what led many in Congress to support a constitutional amendment to force the tough choices. But while getting the deficit down would be a definite plus for the economy's long-term health, doing so by amending the Constitution has some disadvantages. The likelihood that the issue will arise again despite its recent defeat in the Senate makes it important to keep four, in particular, in mind.

First, a balanced budget amendment could turn a mild economic slowdown into a major recession, because fiscal policy will lose its ability to stabilize the economy automatically. As jobs are lost and incomes fall during a slowdown, tax revenues will decline. As more jobless workers apply for unemployment insurance and other benefits, spending will rise. Falling revenues and higher spending could generate a very large temporary deficit. Under the old rules, such deficit spending would automatically boost the weakened economy. But under the new rules, the budget must be balanced. Congress would have to slash spending or raise taxes, either of which would push the economy deeper into recession. And the negative effects of a downturn can linger for a long time, as they did after the most recent recession, which officially ended in the spring of 1991.

But in the amendment just considered by Congress, a three-fifths majority of the House and Senate could waive the budget balance requirements. And often they surely would. But given the uncertainties of economic forecasting, would Congress always act before serious economic damage was done? Would a determined minority in either house ever block a move to waive the budget rules in time of economic crisis, perhaps to delay recovery and weaken the election prospects of the president? Such damage to the nation's economy could all be done in the name of defending the Constitution.

Second, requiring year-to-year budget balance would hold Washington to an extreme standard. Although it is often said that the federal government should balance its budget just as families do, most households do not. Few families pay cash to buy homes, cars, and college educations; they borrow. Businesses borrow to finance inventories or invest in plant and equipment. States issue bonds (borrow) to finance capital expenditures like highways. Year-to-year budget balance would require that the federal government's purchases of long-term capital (buildings, highways, defense equipment) be paid for in full in the year of purchase, a very peculiar accounting standard.

Third, a balanced budget amendment could lead to increasingly outlandish budget shenanigans. Many tools are available to Congress besides direct spending.

Congress could declare certain government expenses to be off-budget. It could impose requirements on state and local governments or on the private sector, perhaps with off-budget loan guarantees to sweeten the pot. Such maneuvers would further undermine the budget process, dragging the debate even deeper into procedural muck and creating even more voter cynicism.

Fourth, a balanced budget amendment raises difficult enforcement questions. Suppose spending exceeds revenue in 2004? Would the federal courts enforce the balanced budget amendment? Would they raise income taxes? cut Social Security benefits? Would they, as Bill Frenzel, a former Republican Congressman now at Brookings, puts it, “send the U.S. marshals in to arrest the check writers?” Whatever the case, Congress and the president would have ceded much of their authority to unelected judges. Suppose instead that the amendment is simply ignored or sidestepped with creative accounting, something like Prohibition earlier this century. Although such a move might ease a temporary budget crisis, it would damage respect for the rule of law and voters’ confidence in their government.

A Challenge Unmet

The fundamental economic challenges facing the nation, including sluggish growth in real wages and productivity for today’s workers, diminished economic prospects for our children and grandchildren, and a further falling behind of those at the bottom of the income distribution, go well beyond the budget deficit. Any solution to these problems will require greater investments in our future, and deficit reduction—which frees up the nation’s savings for productive investment—is surely a step in the right direction.

But the “Contract with America” may not move us in that direction. It does not specify how the budget would be balanced, and once Social Security and defense are taken off the cutting table and future tax hikes are ruled out, budget balance will be extremely difficult to achieve. And tax cuts today—unless paid for by spending cuts or tax hikes elsewhere—only make it harder to balance the budget.

Nevertheless, most Americans support the concept of a balanced budget amendment. A January 12 *Wall Street Journal* opinion poll showed approval at almost 70 percent. Americans do not, however, support the painful deficit reduction that the analysis here shows will be necessary to actually balance the budget. The same opinion poll finds that 60 percent of Americans oppose the amendment if it entails substantial cuts in entitlement programs such as Medicare, Medicaid, and veterans’ benefits.

The contract perfectly mirrors this inconsistency in public opinion, promising budget balance without pain. Its failure to come to grips with budget arithmetic perpetuates the myth that the nation’s fiscal problems can be solved without sacrifice by most Americans. The contract’s supporters, Republicans and Democrats alike, are merely deferring the political debate we must one day have over how to get the deficit down and how to improve the nation’s long-run economic prospects. ■

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Congress after 1994

POLITICAL TIDES AND INSTITUTIONAL CHANGE

The Republican sweep in the fall elections has occasioned much speculation on its effect, for good or for ill, on the nation. But what are its implications for Congress itself as a governing institution? However one interprets the 1994 elections, they are already altering how Congress operates, what policy items are pushed to the top of its agenda, and how such policies are likely to be processed.

Remember There Are Two Houses

Despite the evenness of the Republicans' return to power in Congress (roughly 53 percent of the seats in each chamber), the elections by no means had the same effect on the Senate and the House of Representatives. Under Democratic rule, the Senate and House retained and even accentuated their contrasting institutional hallmarks. Procedural disputes between the two chambers actually intensified. The 1994 elections did not eradicate these differences.

As a majoritarian institution, the House has changed dramatically. The rules of the 104th Congress, with changes crafted in the Republican Conference and adopted on the floor by a series of lopsided votes, embrace many elements drawn from past minority-party complaints. The changes rival in magnitude the great landmarks of the past—the “Reed Rules” of the 1880s, the anti-Cannon revolt of 1909–1910,



the Reorganization Act of 1946, and the "reform era" of the 1960s and 1970s.

The engine of these changes is a powerful, centralized leadership reminiscent of "Uncle Joe" Cannon's turn-of-the-century rule and glimpsed only fleetingly since then. This new speakership actually dates from the 1970s, when majority-party reformers fought to counteract the committees' "old bulls." Speaker Thomas P. "Tip" O'Neill (D-MA) exploited the tools bequeathed by the reformers without alienating policy protagonists. His successor, Jim Wright (D-TX), pushed his prerogatives so relentlessly that his enemies, most notably Newt Gingrich (R-GA), unleashed a successful effort to oust him. Although Wright's successor, Thomas S. Foley (D-WA), pursued a kinder, gentler course, the speakership and its newly accumulated powers remained intact. Among many ironies, Speaker Gingrich will follow not in Foley's footsteps but in Wright's.

To the powerful speakership he inherited, Gingrich has added new elements. Using the leverage of his loyal followers, he was able to name committee leaders (sometimes departing from seniority) and consolidate leadership control of committee assignments and housekeeping matters. Under the new House rules, the majority leader, not the committee chairmen, wields procedural control of limitation amendments ("riders") on funding bills.

The Senate, an individualistic institution, is less prone to sweeping change. For calculating winning coalitions the number 60 (the majority needed to shut off a filibuster) has replaced the number 51 (the normal legislative majority). Thus leaders must seek cross-party alliances. The Republicans have fewer seats than the Democrats had in the last Congress and are at least as constrained by intra-party divisions. Despite the conservative coloring of the GOP Class of '94, a core group of moderates (six to eight or more on given issues) will be the object of ardent lobbying from both sides of the aisle.

Recent experience with Senate party turnovers in 1981 and 1987 further leads one to expect less than cataclysmic changes. In 1981, regaining power after a 26-year hiatus, GOP leaders instituted innovations to coordinate committee actions and plan Senate business, but the reforms did not endure.

The "new Senate" created in the 1960s and institutionalized in the 1970s survived virtually intact into the 1990s. Senate folkways, including personal assertiveness, committee and subcommittee autonomy, and large staffs, although initially associated with the ascendancy of liberal Democrats, persisted because they seemed to serve the interests of all senators, regardless of party or ideological bent. Thus senators have resisted major procedural reforms or staff cuts: although they have moved to trim committee spending and limit subcommittees, their most drastic proposals are aimed at others—for example, eliminating all joint committees and the Office of Technology Assessment.

Another lesson of the 1980s is the Senate's potentially pivotal role in a period of divided government.

In 1981 Senate Republican leaders persuaded the Reagan White House to stress its economic agenda and soft-pedal the so-called social issues. Initially the Senate spearheaded the president's economic program, pressuring the Democratic House to follow suit. After the first year, Senate leaders grasped the initiative from the White House and provided leadership, again forcing the House to respond. The Senate may now find itself in a quite different mediating role—between a Democratic president and a conservative Republican majority in the House.

Limiting Terms, the Old-Fashioned Way

Aside from the partisan shift, the sheer influx of new members is the most potent legacy of the 1994 elections. The 1992 elections had brought 110 new House members (87 returned in 1995)—the largest incoming class in two generations—and (eventually) 14 new senators. The 1994 contests added 86 new representatives and 11 new senators. When the House convened in January, nearly a majority of its members had been elected in the 1990s. The Senate's membership is less altered, but still significant. Twenty-nine senators who serve in the 104th Congress were elected in the 1990s.

Perhaps the greatest public service performed by the voters of 1994 will be to mute the hue and cry for mandated term limits. "Elections," remarked Rep. John A. Boehner (R-OH) recently, "are the best way to clean up the House." Among Republicans, the tactical appeal of term limits will surely fade. Majority Leader Dick Armey (R-TX), for example, has declared that "now, if we can straighten out the House, we can make it function properly, democratically, and efficiently, then I think Americans will find their enthusiasm for term limits waning quite a bit."

Those who worry about the health of legislative institutions have reason to hope Armey is right. Without recapping the pros and cons of the dreary term-limits debate, it seems obvious that 1994 validates the salutary effects of the electoral marketplace on legislative bodies. First, such an election conveys a crisp "message" from the electorate that could hardly be duplicated under term limits. The ins are out, the outs are in. Republicans have been handed a singular opportunity to innovate and prove what they can do. True, voters do not always speak with such clarity, but their messages would be muddled indeed if turnover were mandated for, say, about one-third (according to the most radical proposal) to one-sixth of the legislature.

Second, and even more important from an institutional perspective, the election confirms the need for experienced senior members as well as newcomers. As the Founders recognized, the incentive of reelection is the best way to ensure responsible public officials. And what T.V. Smith called the "legislative way of life" must be learned through disciplined observation, experience, and study of parliamentary procedures and complex policy issues. Even the most attentive members need several years to accumulate the necessary knowledge and skills. Like other organizations, legislative bodies work best with a mixture of expe-

**ROGER H.
DAVIDSON**

*Roger H. Davidson
is professor of govern-
ment and politics at
the University of
Maryland. He is co-
editor of The Ency-
clopedia of the U.S.
Congress (Simon and
Schuster, 1995) and
co-editor of Remaking
Congress (CQ Press,
forthcoming).*

The House and Senate transitions
of the 104th Congress demonstrate
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But seasoned leadership was indispensable
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rienced seniors and new blood—often featuring mentor-learner relationships, always with the possibility of creative friction.

The House and Senate transitions of the 104th Congress demonstrate eloquently the desirability of a mixture of junior and senior members. New blood is vital to the health of any institution, whether it be General Motors, the College of Cardinals, or the U.S. Congress. Junior members bring physical and intellectual vigor, fresh perspectives, generational diversity, and a heightened sensitivity to shifts in the populace. Many of today's Capitol Hill newcomers defeated incumbents they tagged as too-cozy insiders, or replaced retirees besmirched by the House "bank" affair or other scandals; many promised the voters they would shake up the way Washington works. With little power to lose and scant attachment to tradition, junior members are a potent clientele for reform.

But seasoned leadership was indispensable to the Republican takeover. The Senate GOP boasts many veteran lawmakers: Majority Leader Robert Dole's 26 years in the Senate is exactly average for the Republican team's core members. In the House, veterans proved even more crucial. Speaker Gingrich (9 terms), Majority Leader Armev (6 terms), and parliamentary expert Robert S. Walker (10 terms), among others, were on hand to guide the horde of newcomers. The GOP's committee leaders are even more seasoned: despite several deviations from seniority rankings, the new House chairmen boast on average 9.65 terms. Not one of them would be on hand under even the most generous term-limit scheme.

Veterans provide not only expertise and institutional memory, but also a reform agenda that change-oriented newcomers can support, yet could not possibly conceive on their own. Post-World War II modernizing reforms embodied in the 1946 Legislative Reorganization Act—aimed at streamlining committees, professionalizing staff, and centralizing budget-making—were in large part borrowed from scholarly canons of public administration. The 1974 "Watergate-class" committee and caucus reforms pursued an agenda developed over a period of years by liberal Democratic reformers, chiefly in the Democratic Study Group. The 1990s reform agenda was incubated mainly within the House Republican Conference, awaiting only the votes to pass it.

The New Reform-Era Agenda

Agitation for changing the way Congress does its business did not materialize overnight. The past decade witnessed mounting tensions between senior leaders and junior members, between appropriators and authorizers, between House and Senate members. Most troubling was the acrimonious and escalating combat in the House between an entrenched, sometimes overbearing, and increasingly desperate Democratic majority and a restless, aggressive, and sometimes reckless Republican minority. Bitter skirmishes erupted over the Democrats' partisan resolution of a 1984 contested election in Indiana's 8th District, their harsh treatment of the minority, especially during Wright's speakership (1987–89), and their alleged complicity in the House "bank" affair that surfaced in 1991. But the partisan war was fought on many battle-

grounds—on the floor, in committees, in public forums, in local campaigns.

The GOP reform proposals—eight of which were cited in the “Contract with America”—had been refined and expanded during the 103rd Congress. On January 5, 1993, answering the Democrats’ proposed changes in House rules, Gerald B.H. Solomon (NY), the ranking Rules Committee Republican, offered the party’s 43-point “Mandate for Change in the People’s House”—a detailed series of proposals for committee and floor procedures, budget process, legislative-executive relations, and housekeeping matters. Later that year, the Joint Committee on the Organization of Congress—urged by reform-minded members and only reluctantly agreed to by Democratic leaders—compiled volumes of testimony and hundreds of proposals for reform. The effort ended in failure especially frustrating to House Republicans. Vice Chairman David Dreier (R-CA) charged that the chairman’s markup bill was “neither bipartisan nor comprehensive,” noting that it addressed neither committee jurisdictional realignment nor major procedural changes. During the acrimonious markups, 33 GOP strengthening amendments were offered. Eight were accepted, but no fewer than 25 failed in 6–6 party-line votes—which Dreier denounced as “the attempts of a small but vocal faction of the Democratic caucus to derail this effort.”

The Republican Conference was thus primed to overhaul House structures and procedures, even to tackle the contentious and long-overdue task of realigning committee jurisdictions.

The Conference first took aim at easy targets for revision or elimination (actually, transferring their work to other panels). It closed down three committees closely linked to Democrats’ clienteles: District of Columbia, Post Office and Civil Service, and Merchant Marine and Fisheries. It also consolidated a few jurisdictions—most notably financial institutions, transportation, and nonmilitary nuclear issues.

Promised cuts in members’ assignments and committee sizes proved fairly modest. But the new House rules will encourage members to concentrate on committee duties by requiring them to be present for votes (no more proxies or “rolling quorums”), by publishing votes on committee reports, and by further restricting committee meetings while the House is in session.

GOP leaders for the most part showed commendable restraint in dealing with the opposition. To give their foes a taste of their own medicine, the Republicans had only to readopt the rules of the Democratic 103rd Congress. Instead, the new rules reaffirm the minority’s right to offer motions to recommit measures to committee—often the only chance to get a vote on the minority’s alternative bill.

Plus Ça Change. . . .

Despite their activist agenda, GOP reformers were by no means immune to the forces of inertia that stymied reformers in the past. The “laws” of reform politics have not been repealed.

First, support for reform fades quickly when specific proposals are put forward. Dreier, the GOP’s point man on committee realignment, floated a series of plans that ranged from drastic to minimal changes. Predictably, the

more drastic were dropped. “We are trying to find a middle ground, at the same time making a bold dramatic change,” Dreier explained.

Second, influential lawmakers, aided by outside clientele groups, are quick to mount counteroffensives to preserve “their” committees. Many alliances were bipartisan; some were Republican-oriented. Narrow-gauge committees such as Small Business and Veterans’ Affairs would be candidates for elimination under any sensible reorganization plan, but their clienteles were too potent to be snubbed.

Third, those who expect to lose power are invariably more vocal than those who stand to gain. Domains of the powerhouse committees were still hard to breach. Even members who had yet to wield a gavel resisted surrendering their hoped-for patrimony. Carving up powerhouse committees like Energy and Commerce or Ways and Means seemed an urgent priority when they were chaired by the likes of Democrats John Dingell (MI) or Dan Rostenkowski (IL); but when the chairs were Republicans Thomas Bliley (VA) and Bill Archer (TX), the script quickly changed. In the end, little damage was done to the former committee, none at all to the latter.

Fourth, where you stand depends on where you sit—as true in reform politics as in any other. What appeals to a minority party bent on amending or halting action is apt to impede a majority party charged with scheduling and passing legislation. The more partisan of the 43 points urged by Republicans in the 103rd Congress were forgotten in the 104th Congress. No one pressed, for instance, for a bipartisan House Oversight Committee or a minority-controlled Government Reform and Oversight Committee (to use these panels’ trendy new names). Fair committee ratios are fine for the minority, but a majority party needs firm control of the Rules Committee and perhaps other key panels as well. (The GOP had no qualms about keeping the majority’s 9–4 margin there.) Even restrictive rules for floor deliberations—which drew Republican ire in the 1980s and 1990s—will prove essential if the majority is going to protect its priority measures from bothersome minority-party amendments.

Finally, successful reformers are bound to be disappointed. New arrangements don’t always work out the way they are supposed to. Invariably they have results that are wholly unexpected or even antithetical to their purposes. The 1946 reform slashed committees but hastened subcommittee proliferation. Committee reforms of the 1970s made seniority leaders more responsive but inhibited bargaining across party lines. One generation’s reforms become the next generation’s stumbling blocks.

Nowhere is this more likely than with the “big-ticket” items of the GOP reform agenda—term limits, a balanced budget amendment, supermajorities for tax laws, line-item vetoes for funding, regulatory “budgeting,” an inflated investigatory apparatus, and drastic cuts in staffs, facilities, and support agencies. All these devices carry immeasurable implications for the work of Congress and the federal government. Many threaten to limit Congress’s influence and effectiveness as the people’s representative at the federal level. Citizens who cherish representative assemblies—conservatives no less than liberals—ought to question whether weakening legislative capacities is ultimately in their best interest. ■

Bill Clinton and the GOP Congress

THE PERPETUAL TRANSITION MEETS THE MODEL TRANSITION

*Charles O. Jones is Douglas Dillon Visiting Fellow
in the Brookings Governmental Studies program.*

*He is completing On Becoming President: The Passage
from Campaigning to Governing.*

The presidency of Bill Clinton was a work in progress when the fall mid-term elections dramatically altered national politics. Ever in transition, the Clinton White House now faces a well-defined and energized counter-government on Capitol Hill. Working with, and against, this new Congress is an extraordinarily demanding assignment for the president.

Indeed, no election in this century offers a real precedent for what happened in the 1994 elections. The last first-term president whose party lost its House and Senate majorities in the mid-term election was Dwight Eisenhower, in 1954. But his party's loss was no match for the Democrats' recent debacle. The 1954 Republicans' net loss of 19 seats in the House of Representatives gave Democrats a 232–203 edge there. A net loss of only one seat gave the Democrats a 48–47 majority in the Senate (with one independent). And in 1954 Democrats were more or less reclaiming their own territory: they had been the majority party for all but four years in the Senate since 1932 and in the House since 1930. Nor was President Eisenhower a major issue in the 1954 campaign.

The substantial first-term losses for elected presidents during this century, detailed in table 1, are of two types. In 1910 and 1930 Republicans suffered large losses—comparable to those of the 1994 Democrats—in both houses but gave up their majority in the House only. In the presidential elections that followed, both Presidents Taft and Hoover were resoundingly defeated.

In the mid-term elections of 1914, 1922, and 1966, presidents who had won landslides two years before—and whose coattails had helped win inflated majorities for their parties in Congress—suffered large losses but kept working majorities in both Houses. In the subsequent presidential elections, Wilson won reelection narrowly (the smallest Electoral College margin in this century), Coolidge (having assumed the presidency after Harding died in 1923) won handily, and Johnson did not seek reelection.

One other first-term president whose party was trounced in mid-term congressional elections—Harry S. Truman in 1946—has been of particular interest to the Clinton White House, no doubt because of Truman's come-back victory in 1948. The Democrats did lose big in 1946, suffering net losses of 55 House seats and 12 Senate seats. Further, the 80th Congress is the only other post–World War II case of a Democratic president and a Republican Congress.

But the parallels between 1946 and 1994 stop there. Truman was not an elected president in 1946. In fact, he was a reluctant candidate for vice president when Roosevelt decided to dump Henry Wallace in 1944. Nor was Truman active in the 1946 campaign. Advised to remain silent, he did. The Republicans' question "Had enough?" referred as much to the 14 years of Democratic rule as to Truman himself as president.

And the 1946 congressional Republicans had no "Contract with America" to be voted on in their first 100 days. In fact, Arthur Krock concluded in his post-1946 election analysis that the Republicans had devised no strategy to manage their landslide. As they surveyed the advantage for 1948 of "carrying Congress . . . against a president of the opposite party in mid-term" and "the disadvantage of public responsibility for the record of Congress in the interim," they were uncertain how to proceed.

Newt Gingrich had no such trouble in 1994.

The Bold New Opposition

Normally a mid-term election is hard to interpret. The president is not on the ballot, though the inclination is to see the results as a test of his administration. "All politics" is said to be "local" and it is usually difficult to identify a national theme to explain the outcome. With only one-third of the Senate seats up for election, it is hard to generalize about issues and party strength. Turnout varies greatly throughout states and congressional districts. And a mid-course adjustment may naturally follow a substantial party win in a presidential year.

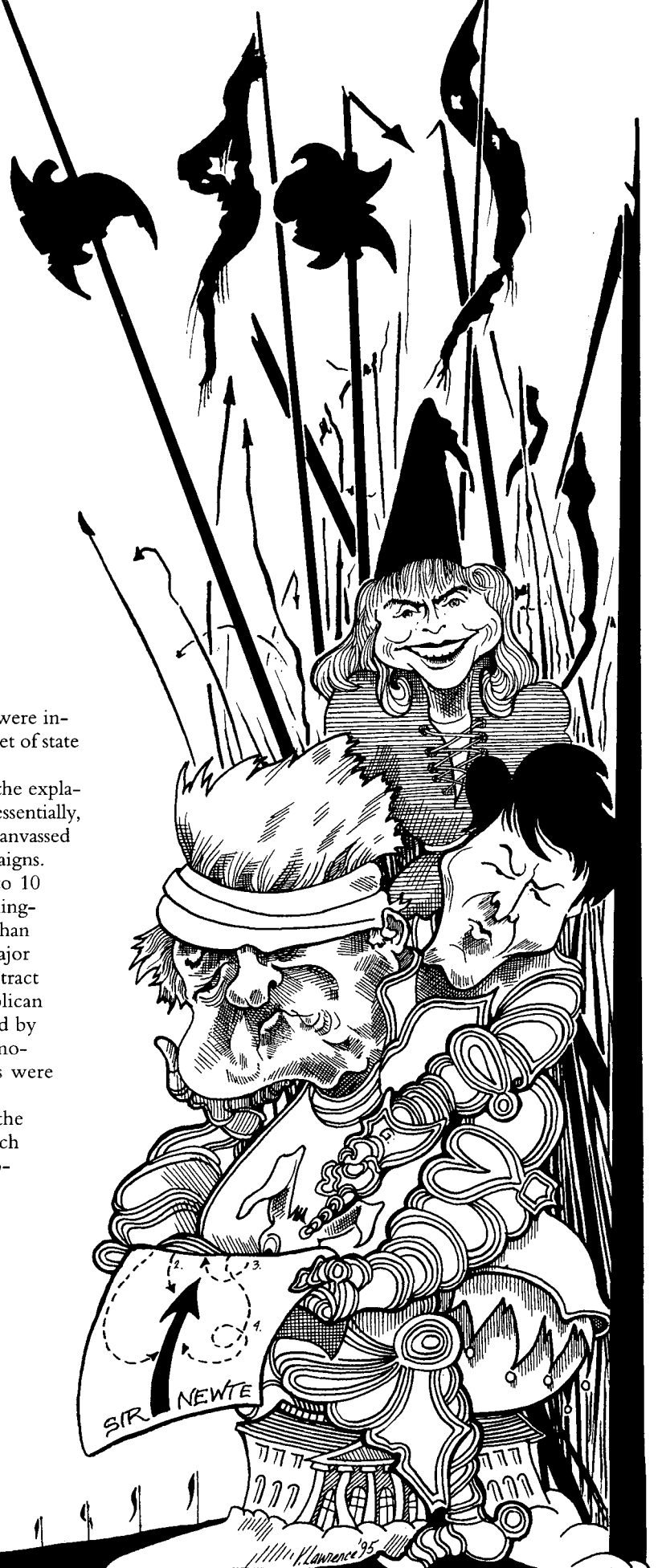
In 1994 the political stars were aligned to permit an extraordinary mid-term election, one that invited all the talk of a mandate. The following exacting conditions were met:

- a set of national issues that displayed ideological differences between the political parties;
- unity on the issues within the winning party;
- a huge win by one political party that was national, not regional, and pervasive among important offices;
- losses attributed to the president, due either to his having campaigned or to candidates having run against him;
- a victory that exceeded expectations.

A mid-term election was nationalized, and the results were interpreted as a mandate. How did this happen? How did a set of state and local elections produce a coherent message?

Surely the "Contract with America" was a big part of the explanation. Developed over several months, the contract was, essentially, a bold party platform. House Republican candidates were canvassed last summer to identify the principal issues of their campaigns. Polling and focus groups helped pare the resulting list to 10 items and fine-tune it. All candidates were invited to Washington on September 27 to a rally on the Capitol steps. More than 350 incumbents and candidates signed the contract in a major media event. The promise was that the items in the contract would be voted on in the first 100 days of a Republican Congress. Many of the legislative proposals—bills offered by House Republicans and defeated (or bottled up) by Democratic congresses—were ready to be introduced; others were drafted in the hectic last days of the 103rd Congress.

Many Democrats, including the president, mocked the contract and appeared delighted to run against it. Gingrich and friends were widely thought to have made a serious political blunder: Republicans were bound to do well anyway in the election and the contract could be used by Democratic candidates against their challengers. Democratic consultant Paul Begala was quoted as saying, "There is not a night I don't thank God for the contract." The Democratic National Committee, resorting to money rather than prayer, allocated two million dollars for television spots critical of the contract. In the final days of the campaign President Clinton slammed the "Contract on America," pointing out the damage it would do to Social Security and Medicare.



Gingrich reveled in the publicity. Indeed, he published the contract in *TV Guide*, a magazine with a circulation of more than 14 million. And the more the Democrats and pundits drew attention to the contract, the more likely it was to have force if House Republicans did well on November 8. Meanwhile Gingrich made it clear that he was running for Speaker of the House. He planned publicly in advance for the takeover—behavior normally judged too brash for presidential candidates in the midst of a campaign.

If the Republicans did win, breaking the Democrats' 40-year lock on the House, there would be no doubt in anyone's mind that Newt Gingrich was the leader most directly associated with the win. And win they did. Not one Republican incumbent—House, Senate, or State House—was defeated. The GOP captured the Senate with a net gain of 8 seats, much as predicted. (Richard Shelby of Alabama added to their margin by switching parties the day after the election.) The surprise was in the House, where the Republicans, with a net gain of 52 seats, took command for the first time since 1954.

The Model Transition

Gingrich and his team managed the transition to a Republican House much as they managed the election. In the manner of a prospective president-elect Gingrich appointed a 10-member transition team, headed by Jim Nussle, a second-term member from Iowa. Opting for youth over experience in organizing the takeover, Gingrich appointed one other second-term member and five first-term members to the transition team, charging them to prepare recommendations for the meeting of all House Republicans in conference on December 5. Gingrich and his team meant to use the normally quiet period following the election to make sweeping changes and to dominate press coverage. They also intended to work Congress hard during the usually slow months of January and February. Having been given their first chance in two generations to control the pace of work in the House, Republicans judged they had no time to lose.

In the days leading up to the opening of the 104th Congress, the Speaker-apparent, typically pulling the contract from his vest pocket, frequently repeated his pledge to bring its chief policy measures to a vote in the first 100 days. The contract, now the policy touchstone for House Republicans, included proposals on crime, welfare, tax cuts, families, defense, Social Security, business incentives, and tort reform, and compelled responses by the White House and the Senate (where Republicans offered a complementary set of proposals called "Seven More in '94"). Gingrich and his team successfully asserted that the agenda was theirs, that others should either accept that fact or step aside.

The very first day Congress met, the new Republican majority made dramatic reforms in House procedures. In yet another display of youth, and as a reminder, as well, of the change produced by the election, the leadership designated newly elected members to introduce the rules changes. The energy and dedication of the transition defy description. No House Republican in the 104th Congress had ever be-

fore served in the majority. Twenty-six of the new House Republicans were not even *born* when Republicans last held the majority in the House. All were excited, even giddy, over their assumption of power. It was an historic moment that, in itself, invited unity of purpose and high expectations.

The Bewildered White House

Although the Republicans surprised most experts by actually taking over the House, they had been expected to make big gains and surely to win more than 192 seats, their highest number since 1954. And it was commonly predicted that they would win control of the Senate. In short, no one doubted that the 104th Congress would look very different from the 103rd. But if White House strategists had included a worst-case scenario in looking ahead to the election, it was not evident from the president's reaction.

Clinton's November 9 post-election statement stressed his record. Professing agreement "with much of what the electorate said yesterday," he offered an interpretation quite at odds with how others viewed the results. As he saw it, the election was more about the change that brought him to Washington in 1992. Inferring that the voters "were not satisfied with the progress we had made," he concluded that the new Republican leadership would therefore have to "work with me." By his reading the voters "looked at us and they said, we want some more changes, and we're going to try this and see if this works." He then departed for Indonesia for an ill-timed conference on trade with Asia.

Meanwhile most analysts were concluding that the president's record received poor grades in the election and that the initiative was now with the Republican Congress. Failing to meet the high expectations of unified Democratic government, Bill Clinton had achieved what even landslide-winning Republican presidents could not—a Republican majority in the House.

On December 15 the president addressed the nation from the Oval Office. In a regular presidential transition, mid-December is a time for announcing major cabinet appointments, thus signaling the shape of the new government. Following the mid-term elections, the president might have used the occasion to announce several key new appointments, as well as organizational adjustments in preparation for the challenges ahead. Instead, Clinton joined the Republican call for tax cuts, to be offset by spending cuts, while professing to eschew "politics as usual" for the next two years. The speech, which not only failed to clarify the second transition, but also fed the image of the president as too willing to follow rather than lead, was roundly criticized. Robert J. Samuelson, writing in the *Washington Post*, judged it to be "the nadir of his presidency."

The president's lengthy State of the Union message on January 24 fared little better with the analysts. He proposed an indeterminate "New Covenant" by which government would provide opportunities and promote responsibility. The message was crafted to place the president more in the political center by redefining the role of government as "a partner to help us to do more for ourselves and for each other." David S. Broder

wrote, "It was a speech about everything, and therefore about nothing. It was a huge missed opportunity."

The 104th Congress

What do the next two years hold? Is gridlock inevitable? At the national level, government has been divided—with the president of one party and Congress of the other—more often than not since 1946. We know how to govern under those conditions. Near-total gridlock, like that of the last two years of the Bush era, is the exception, not the rule. Divided governments have produced the Marshall Plan, Taft-Hartley, the interstate highway system, trade reform, Social Security reform, tax reform, the War Powers Resolution, comprehensive energy legislation, and deficit reduction. Not a bad record, that.

Nor is having policy initiative shift to Capitol Hill unprecedented. In 1986, when Democrats recaptured majority status in the Senate and retained a sizable majority in the House, Richard A. Gephardt, Chairman of the House Democratic Caucus, proclaimed that "The Reagan era is ending. This is our time to lead." Little was expected of the 100th Congress working in harness with a "lame duck" president of the other party. Yet the new Speaker of the House, Jim Wright of Texas, promoted an ambitious policy agenda that contributed to a creative tension with the White House. Defying predictions, the 100th Congress produced more major legislation than any other during Reagan's two terms.

The task for President Clinton is clear. He must conduct a second transition, not having fully completed the first. He must establish his priorities and define the purpose of his presidency. Like all presidents, he has available four approaches to congressional relations. He must conduct an inventory of issues to make the appropriate choice.

In some cases he may pursue a *partisan*, no-compromise strategy, relying ultimately on the veto to situate his position and build his record. Presidents Truman, Ford, and Bush all used the veto effectively.

In other instances he may prefer a *copartisan* strategy by which he proposes alternatives to Republican initiatives, staying with that alternative to the point where compromise is essential to save the legislation. George Bush made good use of that strategy during his first two years.

He may also use a *cross-partisan* strategy to gain support from the other party on certain key issues. In the past southern Democrats have been available to Republican presidents on certain issues; President Clinton has been able to count on Republicans for trade agreements.

The final, *bipartisan*, strategy has been counted on by presidents most often for foreign and national security issues. The term itself, commonly used to designate any significant cross-party effort, is properly reserved for serious foreign or domestic issues, on which parties are willing to work together from the start.

Split party governments work best when each side is strong and resourceful. Weakness at either end of Pennsylvania Avenue can result in imbalance, as with the dominance by Reagan in 1981 or by the post-Watergate Democratic Congress in 1975–76. If both are

Table 1. Dramatic Congressional Losses for First-Term, Elected Presidents, 1901–95

PRESIDENT	ELECTION	NET LOSS IN HOUSE	NET LOSS IN SENATE	LOSS OF MAJORITY?
Taft	1910	57	10	House only
Wilson	1914	59	—	No
Harding	1922	75	8	No
Hoover	1930	49	8	House only*
Johnson	1966	47	4	No
Clinton	1994	52	9†	Both houses

Source: Norman J. Ornstein, Thomas E. Mann, and Michael J. Malbin, *Vital Statistics on Congress, 1993–1994* (Congressional Quarterly, 1994), p. 53.

* The Republicans retained a narrow House majority in the 1930 elections but because of deaths the Democrats had a majority by the time Congress met.

† Includes Richard Shelby (D-AL) who switched parties after the election.

weak, as during the last two years of the Bush administration, partisan stalemate or gridlock can result.

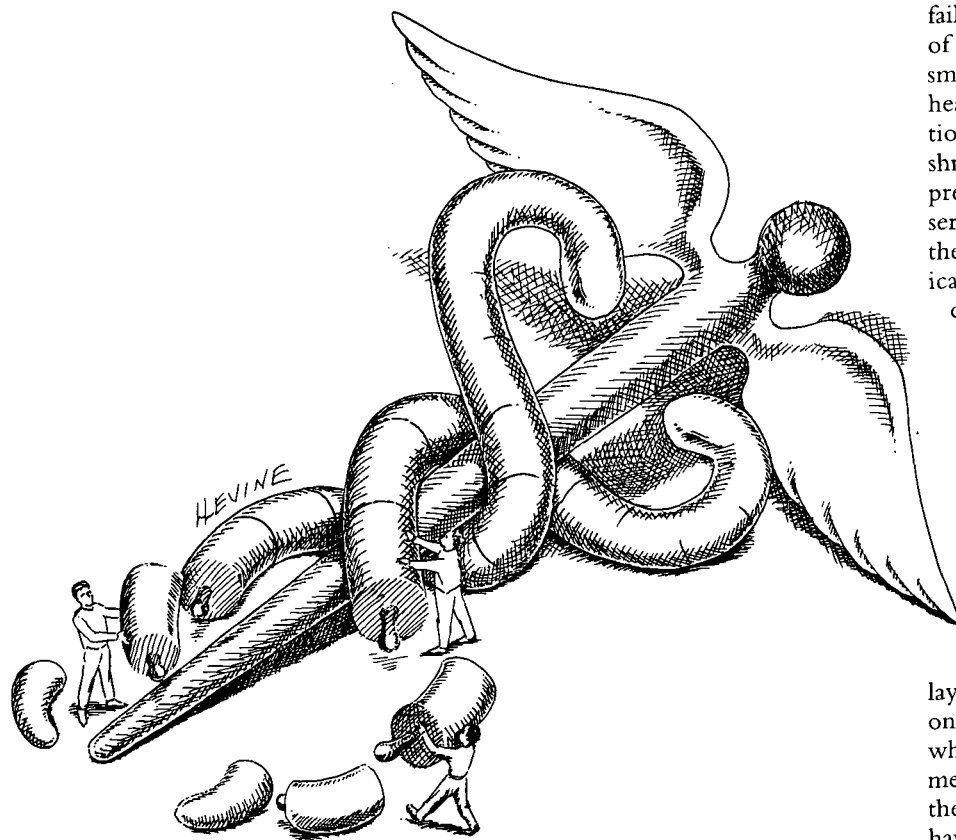
Whither the Gingrich Steamroller?

It is too early to judge how the 104th Congress will develop and ultimately be rated. Yet this much can be said. President Clinton was strongly associated with the Democratic defeat in 1994. A study by David Brady, John Cogan, and Douglas Rivers found that: "The more the Democratic incumbent voted to support the president's policies, the more likely he or she was to be defeated." Thus the standard political exercises of credit claiming and blame avoidance are vastly complicated for Clinton in 1995. Initially the House Republicans under the leadership of Speaker Gingrich clearly have the edge. Their win made the news, and their preparations facilitated a remarkable transition to majority status.

But the House of Representatives is one chamber of one institution in a system of separated powers, and the issues of the "Contract with America" are far-reaching and controversial. The more deliberative Senate spawns various forms of partisan interaction and ever shields the minority party. And the president has the status and power of his office, if those advantages are preserved and nurtured. The challenge for Bill Clinton is to complete his presidency so that he can realize the advantages the institution has to offer.

One final observation. Mandates aren't forever. As concocted readings of election returns more than policy directives from voters, they are given and they are taken away. Further, the principal recipient of this mandate, Newt Gingrich, was elected not by the nation but by his colleagues. His approval scores with the public are no more impressive than the president's. With time, and as reforms settle in, a more regular lawmaking process will emerge, one featuring the redundancies and checkpoints that perpetuate access and preserve America's separated system of government. ■

Small Steps



**HEALTH CARE REFORM
IS STILL POSSIBLE**

THE HEALTH CARE REFORM debate of 1994 disappointed most of its participants. The president saw his most important domestic initiative fail to come to a vote in Congress and contribute to his party's most devastating congressional electoral defeat in half a century. Many Republicans who also wanted to reform health care financing were spurned by the fractious Democratic majority and by their more conservative colleagues. The big winners in the debate were those conservatives who believed all reform plans were worse than no action at all and who sought to use health care reform as a symbol of Washington bureaucratic elephantiasis to cudgel Democrats. They saw inaction as the best course from the standpoint of both public policy and political strategy. For them the experiences of the past two years are a vindication.

For the rest of the Congress, most Democrats and a sizable fraction of Republicans, who wanted federal action but could not agree on what, the failed health care reform debate raises the question of whether meaningful reform is still possible in smaller increments. For although the failure of health care reform in 1994, buttressed by the election of a Republican Congress determined to shrink the federal government, has removed comprehensive reform from the national agenda, the serious problems that spurred the reform effort—the lack of health insurance for 40 million Americans and rising national spending on health care—remain.

Three sets of initiatives may hold out some potential of garnering support from both Republicans and Democrats to begin to attack both problems.

Paying for Medicare

A first step would be to respond to the need to reform the financing of Medicare, the program of health care for disabled and elderly Americans. By about 2002 payroll taxes and accumulated reserves will prove inadequate to cover Medicare outlays for hospital benefits. Premiums cover barely one-quarter of the costs of payments to physicians, which are rising at about twice the rate of gross domestic product; general government support covers the balance. Some Republicans and Democrats have expressed interest in replacing the current system, in which the federal government pays for specified services, with a system in which the federal government gives the elderly and disabled vouchers to buy health insurance.

This proposal has several pitfalls, but considerable promise. The first pitfall arises because Medicare payments for services differ widely among the

states as a result of different costs of living in various regions of the country. If the voucher were uniform, beneficiaries in high-cost states such as Florida and New York would suffer sizable losses, or the national cost of the program would greatly increase. Trying to vary the value of the voucher depending on the state in which the beneficiary resides would raise political difficulties. Representatives from such low-cost states as Idaho or South Carolina would be likely to question the fairness of paying residents of Florida vouchers worth almost twice the value of those paid to their own constituents.

The notorious inefficiency of the market for individual insurance is the second pitfall. The Congressional Research Service estimates that 40 percent of premiums for individual insurance go for selling costs and other expenses. If individuals eligible for Medicare are given vouchers, reducing this excessive overhead would be imperative. For example, states could approve health plans and set up centralized marketing arrangements to cut costs. Such arrangements, however, bear a striking resemblance to the much-reviled feature of the Clinton health plan, regional health alliances.

Nonetheless, if they could be implemented, vouchers might encourage the elderly and disabled to buy health services from managed care groups, which achieve economies by negotiating discounts and by curtailing some services. In short, vouchers offer a way to mobilize market forces to promote efficiency and to ration low-benefit services.

School and Neighborhood Clinics

A second area where bipartisan consensus may be possible is federal support for the direct delivery of services through schools or other neighborhood clinics. The advance of managed care and negotiated discounts threatens to reduce the capacity of physicians and hospitals to provide services to the uninsured. Currently, hospitals and physicians charge well-insured patients more than care for these patients costs and use the excess to underwrite care for the uninsured. As managed care operations negotiate discounts and generally squeeze costs, they reduce the scope for such "cross-subsidies." This development, which is a natural consequence of encouraging the operation of market forces to enforce efficiency in health care provision, would weaken a safety net that has protected the uninsured from the full effects of not having coverage. Now that Congress has abandoned the goal of extending access to health insurance by way of universal coverage, it could consider direct delivery of services to the most vulnerable among the uninsured as an alternative. This approach to health care reform enjoyed some Republican support in the past, but Democrats resisted it as a diversion from the larger objective of

comprehensive reform. If Republican support holds firm, Democrats may find that this once-spurned alternative is the best they can do.

Long-Term Care

The final area where bipartisan action may be possible is long-term care. The costs of long-term nursing home and home care services for disabled Americans are not covered to any significant extent by either Medicare or private insurance. Medicaid, the nation's program of medical care for the poor, does cover long-term care and is essentially the payer of last resort for many elderly, who are forced to impoverish themselves to qualify for benefits.

Long-term care services now constitute about 70 percent of the cost of Medicaid. The population of the very elderly is growing rapidly, and Medicaid obligations are growing along with it. An alternative that might have appeal across party lines would be to replace Medicaid support of long-term care with a federal block grant for long-term care to states or voluntary organizations. Such a conversion could serve as merely an antiseptic way of slashing benefits. But it could be a way to give states increased flexibility in allocating funds among providers if the block grant were indexed for increases in the eligible population and for prices and if the states were required to maintain their long-term care outlays so that overall spending did not fall.

The politics of block grants and annual appropriations differs from the politics of the entitlement. As an entitlement, Medicaid payments to the states flow out automatically on the legislated rules unless Congress modifies them. The values of block grants are part of the annual budget and appropriation debates. Particularly if the balanced budget amendment is ratified, the conversion of Medicaid from an entitlement into an annually appropriated sum will greatly increase its vulnerability to deep reductions. The same observation is true of Medicare if it should be converted into a voucher program subject to annual appropriations. Whether that is an argument for or against ending the entitlement status of Medicaid or Medicare depends precisely on one's views of the desirability of such cuts. ■

In collaboration with *Health Affairs*, a quarterly journal on health care policy, Brookings convened a conference last January to address health care reform. Papers presented at the conference will appear as a special issue of *Health Affairs* and, later in somewhat extended form, as a Brookings book. This article reports on some views shared by many participants at that meeting.

**HENRY
J.
AARON**

*Henry J. Aaron
is director of the
Brookings Economic
Studies program.
He is the author
of Serious and
Unstable Condition:
Financing America's
Health Care
(Brookings, 1991).*

ELIMINATE OR

Nuclear Weapons in U.S. Foreign Policy

The decades-old role of nuclear weapons as the cornerstone of Western defense policy is coming into question. As a 1993 Council on Foreign Relations book put it, "From the beginning of the Cold War in 1946 to its end in 1990, the U.S. government would have rejected any offer from the gods to take all nuclear weapons off the table of international affairs." Today, by contrast, such an offer "would deserve instant acceptance."

Lamenting that "no one knows how to abolish nuclear weapons," the book's authors—McGeorge Bundy (special assistant to the president for national security affairs, 1961–66), Admiral William Crowe (chairman of the Joint Chiefs of Staff, 1985–89, now U.S. ambassador to London), and Sidney Drell (physicist and long-time adviser to the U.S. government on security issues)—nonetheless put on record their belief that nuclear weapons diminish rather than enhance U.S. security.

Nor are they alone. In November 1992, former Secretary of Defense Robert McNamara, who has long argued that nuclear weapons have no military value, advocated "returning to a non-nuclear world"—though with the caveat, "insofar as possible." Similar statements are now being made in forums throughout the United States.

Many of these so-called "marginalizers"—as this wing of the current nuclear weapons debate is coming to be known—believe that deemphasizing the role of nuclear weapons in U.S. security policy will lead to their atrophy and ultimate extinction. But only a few marginalizers are ready to accept the logic of that belief: adopt today the policy goal of achieving a nuclear-free world within the next 20–30 years. Most consider that goal politically unfeasible or are daunted by the problem of nuclear breakout.

Their assumption—or hope—is that policymakers

can preserve today's rather reassuringly low-salience nuclear world indefinitely into the future by changing America's stated nuclear doctrine and reducing existing arsenals. But that assumption ignores current international trends and the history of this century and is not a workable option. The real choice is between actively pursuing a nuclear-free world over the next quarter century or returning inevitably to the high-salience nuclear world from which we have just been set free. What are the risks and benefits of these alternative courses, with particular reference to the ultimate danger of a nuclear exchange?

International Prospects

The present lull in great power confrontation is a historical anomaly, brought about by the collapse of the Soviet Union. Failing a radical change in Western policies now, the conjunction of two historical trends suggests that world affairs in the future will be at least as turbulent as in the past.

One trend is the end of European global domination, an era that left behind deep resentments in many areas, some of which have been reinforced by the experience of the past 30–40 years. The other trend is differing rates of growth in world populations. Today, for example, Asians outnumber Westerners more than 2 to 1, a disparity for which the West's economic and military power more than compensates. But by 2025, the disparity may grow to 4 or 5 to 1, with no compensating advantages, and may well lead to a shift in hegemonic power.

One needn't subscribe to Samuel Huntington's "Clash of Civilizations" to conclude that a quarter century from now global relations are likely to be at least as conflict-ridden as they were during the Cold War years, albeit in ways that have yet to be foreseen. And despite the lesson of the two World Wars that war is no longer a rational instrument of policy in great-

MARGINALIZE?

power relations, arms racing will remain a feature of the international scene, with nuclear weapons having a totemic value unrelated to military utility.

Experience also suggests that the nuclear arms race will continue to have a logic and dynamic of its own. Even as the superpowers were actively negotiating the successive treaties on strategic arms “limitations” and “reductions,” the number of warheads on each side rose from less than 2,000 to more than 11,000. Nor was the upward spiral a quirk of communist intransigence; the United States was the first to diversify into multiple warheads and strategic cruise missiles, and then it sought to take the arms race into space.

Even after the Soviet Union had disintegrated, the United States proposed a START II ceiling of 4,700 warheads—enough to destroy Russia as a functioning society several times over. And although some “marginalizers” talk of 1,000 warheads by the year 2000, others see institutional obstacles to going below 2,500.

China, meanwhile, continues to add to its nuclear arsenal, and the problem of proliferation worsens. It is generally accepted that halting the spread of nuclear weapons will only grow harder. Technological advance and diffusion have steadily lowered the barriers to entering the weapon business, and 20–30 states already have the requisite technological capacity. It is becoming ever easier for would-be proliferators to design bombs and acquire fissile materials and other components, often exploiting Western commercial competition, while the number of countries that can afford to do so is steadily increasing. And the Gulf War provided the lesson that to be safe from U.S. military intervention, third world states need a nuclear capability.

New problems have also arisen. The Cold War’s end eroded intra-bloc discipline and weakened the constraints that superpowers were able to impose on allies and clients. Weapons-grade material and people with nuclear skills are newly available worldwide. And

if the Soviet Union can disintegrate, why not China, or India, or the new Russian state, and why should the break-up be peaceable? If Muslim political identity strengthens, could Pakistan choose to share its weapons know-how with Indonesia, Malaya, even Iran? Will Japan and Germany always be content with a U.S. security umbrella?

Rumblings in the background is continuing resentment of the two-class nature of the Nuclear Proliferation Treaty, which perpetuates the arbitrary privileging of the five original nuclear states (three of them Western). And dissatisfaction is growing over the five’s failure to meet their treaty obligations regarding nuclear disarmament. Willing acceptance of the NPT’s control and verification measures is less than universal, while Iraq and North Korea have highlighted the problems of policing and reversing evasions.

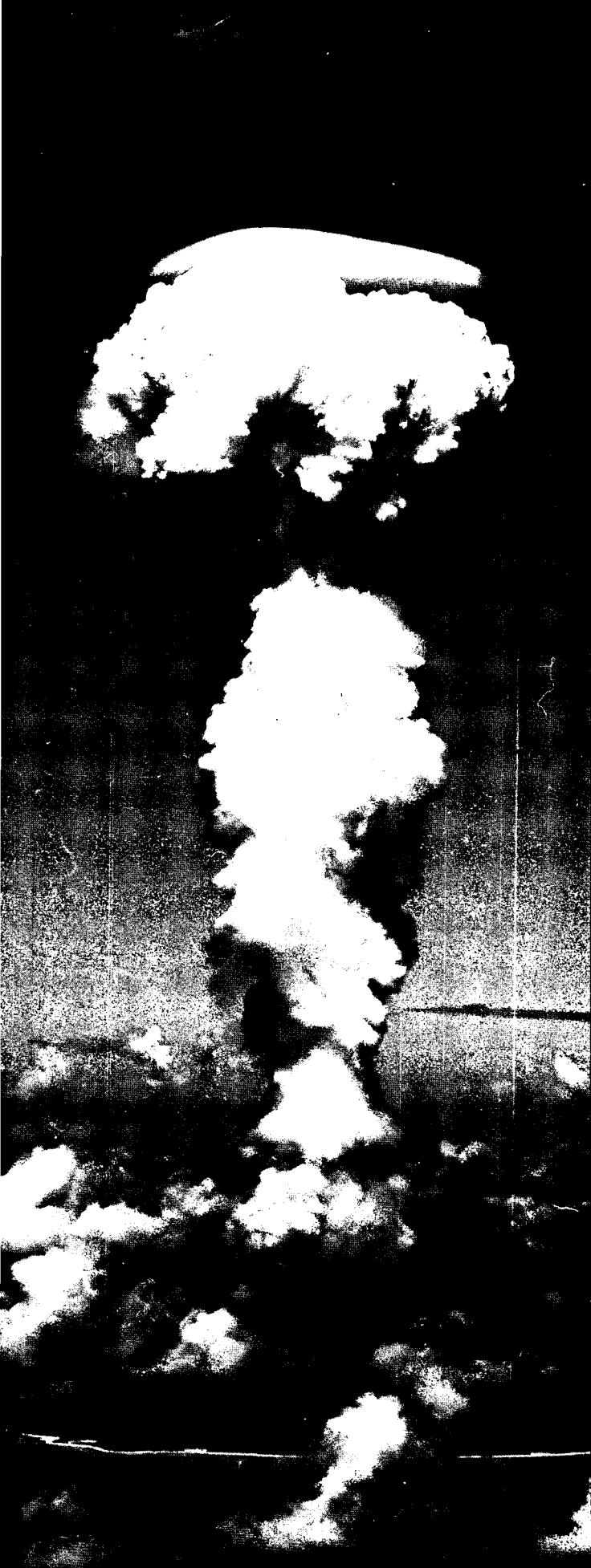
In sum, current trends and past experience suggest that while patterns will change, international relations will continue to be conflictual and will generate arms races. Failing a change in Western policy, we will certainly face a world of many nuclear states within the next several decades, and it is most unlikely that all will settle for minimum deterrence. Nuclear arms racing will surely reappear.

The Danger of Nuclear War

The claim by Western “traditionalists” that nuclear weapons are the key to peace is subject to several problems. The argument that the “very existence of nuclear weapons” accounts for the absence of major war between advanced military powers during the past 40 years is a case of *post hoc ergo propter hoc*. The superpowers, fresh from World War II, were determined to avoid war at almost any cost. By the early 1950s, they had set a pattern of war avoidance that was well established when the strategic nuclear arms race took off in the 1960s. The new danger of nuclear escalation

Michael
McCWire

Michael McCWire is an Hon. Senior Fellow in the Faculty of Social and Political Sciences at Cambridge, England. This article draws on his articles in International Affairs (spring 1994), Brassey’s Defence Year Book (1995), and James Brown, ed., Old Issues and New Strategies in Arms Control (forthcoming, 1995).



merely underlined the point. And nuclear weapons were singularly ineffective in preventing other kinds of war, even in areas of the world where the United States had an effective monopoly.

The nuclear arms race and swollen arsenals did, however, create a particular perception of threat. And that perception was reinforced by each nation's need to maintain the credibility of deterrence by demonstrating its will to inflict massive devastation on its opponent and to suffer it, if need be, itself. The consequent exaggerated rhetoric, aimed at domestic constituents as well as opponents, hardened attitudes and inflamed mutual hostility, heightening international tension.

But war does not stem only from deliberate aggression, which can be deterred by threats of unacceptable punishment. History is replete with examples of inadvertent hostilities—one thinks of the Cuban missile crisis—triggered by mutual misunderstanding or the momentum of events. And in times of tension there is the new possibility of accidental war, a consequence of nuclear-armed missiles. Analysts now know, for example, that the command, control, and communications systems of U.S. and Soviet strategic forces during the Cold War were subject to a significant probability of procedural and systems malfunctions (and hence mistaken activation of strike plans).

The world was immensely fortunate that neither side made a fatal mistake during the 25 years of bipolar confrontation. But what lies ahead is a multipolar game of indefinite duration, where the new players' nuclear command, control, and communications will be more prone to system errors, and each player's understanding of the others' thought processes will be even more rudimentary. Can we still rely on luck? As Robert McNamara puts it, "Human beings are fallible. . . . The indefinite combination of nuclear weapons and human fallibility will lead to a nuclear exchange."

The Alternative—Is It Achievable?

Is a nuclear-free world achievable? Allowing that the process may take as long as 30 years, is it feasible in technical, institutional, and political terms? And if feasible, does the possibility that a state might break out from such a regime invalidate the concept?

To be feasible, three requirements must be met. The nuclear states must embrace the goal and actively support the process. A nuclear-weapons-free regime must be devised and agreed. And nuclear arsenals must be progressively eliminated.

The last requirement is the least problematic. The political, administrative, and technical processes involved in drawing down and dismantling the existing nuclear arsenals have been the staple of arms control specialists for the past seven years, though the move to very low numbers and then total elimination will take some new thinking. Happily, verifying *zero* weapons or warheads is much easier than verifying specific limits.

Similarly, devising an effective nuclear-weapons-free regime and its associated institutions can build on existing experience and practice, most notably the 15-year negotiations leading to the complex but comprehensive legal regime on the use of the sea and its resources and most recently the Chemical Weapons Convention signed in 1993.

The treaty-making process could be structured in many different ways, but in its final form the regime would be governed by a universal treaty of indefinite duration and without the right of withdrawal. Administrative, scientific, and technical problems will be formidable, but not insoluble. A nuclear-free treaty would build on the foundation of existing treaties and agreements relating to nuclear weapons and other weapons of mass destruction. But, unlike the Law of the Sea treaty and successive arms control agreements, negotiations to eliminate nuclear weapons would be favored by a high coincidence of interests among parties.

While the effectiveness of verification measures will be critical to the acceptability and success of a nuclear-free regime, all measures need not be in place before negotiations on the shape of the regime begin, let alone before a treaty of serious intent is signed. The required procedures can be introduced and improved over time, with progressive increases in stringency. The new discipline of control and verification is still in its infancy, the potential of information technology is largely untapped, and with the necessary resources, massive improvements in procedures and scientific techniques are possible. The excuse that "we don't know how" sits ill with a nation that was preparing to spend hundreds of billions of dollars on a futuristic Strategic Defense Initiative.

Account must also be taken of improvements in the climate of international relations consequent to a Western decision to adopt the goal of eliminating nuclear weapons. Enforcing the NPT, for example, would become a matter of universal concern, rather than, as seen by many nonnuclear states, a dispute between haves and have-nots.

Progress toward a nuclear-free world would be paced by the process of dismantling the existing arsenals and establishing the necessary politico-legal regime and its associated means of control, verification, and enforcement. The pressures driving nuclear proliferation would steadily diminish. The security requirement for countervailing force would be progressively removed. The urge to preserve independence in foreign affairs through a nuclear capability would be assuaged by the leveling down process. And while the potential role of nuclear weapons as the great equalizer would remain, it is relevant that the generous supply of U.S. arms to Israel managed to compensate for a gross disparity in numbers.

Will the Nuclear States Agree?

Three developments could push America to commit itself to the goal of a nuclear-free world. One is the growing realization that with the Soviet Union out of the picture, nuclear weapons bring no tangible benefits and pose deadly long-run dangers. Another is the increased importance of the NPT. Acquisition of nuclear weapons by third world states will negate U.S. conventional superiority; and a fully effective non-proliferation treaty (along with good intelligence) is the only counter to nuclear terrorism. The heavily populated cities that line its richly indented seaboard make the United States particularly vulnerable to the devastating effects of waterborne fallout.

The third development concerns possible changes in the distribution of world power. It is in the West's interest to have firmly in place an internationally accepted political-legal regime that can manage such change peaceably. Comprehensive conventions banning nuclear, chemical, and biological weapons would serve as the foundations of such a regime.

If Washington were to adopt the goal of a nuclear-free world, the other nuclear nations would follow suit. Britain and France would fall into line, albeit reluctantly. China, given its conventional potential, has every reason to welcome a nuclear-free world and is on record supporting the idea. A nuclear-free China would remove the rationale for India's and hence Pakistan's capability. (India has officially proposed a nuclear-free world on several occasions.) And Israel recognizes its vulnerability to attack by primitive delivery systems, has shown that its territorial integrity can be ensured by conventional means, and knows that the greatest danger now comes from internal forces impervious to nuclear threats.

And Russia? Given China's potential and the traditional enmity of Germany and Japan, Russia could legitimately claim a continuing need for "the great equalizer." But it was Russia (in the shape of the Soviet Union) that first faced up to the deadly logic of the nuclear arms race and explicitly adopted the goal of a nuclear-free world. The policy predated Mikhail Gorbachev, but he pursued the goal

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with particular vigor and enjoyed strong military support. Through 1992 Russia continued to advocate complete nuclear disarmament, and although current policy is more fluid, last September Boris Yeltsin called for further cuts in strategic weapons to provide the eventual possibility of a nuclear-free world.

The Question of Nuclear Breakout

What if a state manages to “break out” from the nuclear-free regime? Many in the West assume that nuclear breakout would be so dangerous that we should not even set foot down the nuclear-free path, notwithstanding the immediate gains in international security and the broader political benefits of working toward that goal. Such an assumption, however, ignores the changes that will take place once we adopt the nuclear-free goal. By the time we are ready to cross the nuclear-free threshold, all the institutional infrastructure will long have been in place, and all control and verification procedures will have been proven and refined during the intervening years of enforcing the NPT. Meanwhile, the world will have negotiated and agreed on a raft of mutually supporting treaties, conventions, and protocols relating to the permanent elimination of all weapons of mass destruction and the control of all relevant material and technologies. In this and other important respects (particularly attitudes and expectations), a nuclear-free world will be very different from the one we know today.

It must, of course, be accepted that the regime’s controls could be evaded. But it must also be asked what the incentive would be for a state to embark on such a hazardous course. It turns out that the net incentive is much smaller than is generally assumed, partly because no one has yet discovered how to translate the notional power of a nuclear monopoly into practical gains. We have lived with nuclear weapons for 50 years, 10 of which saw a U.S. monopoly, and despite the theorists’ best efforts, no example of nuclear compellence yet exists.

And what about the potential costs to a breakout nation? Unlike territorial claims and questions of aggression, which tie the United Nations into knots, a serious breach of the nuclear-weapons-free regime would be indisputable and would clearly threaten the interests of all other states, rich or poor, large or small. Collective action will therefore be assured, strengthening the deterrent effect of the wide array of available instruments, including conventional weapons, which will by then have become immeasurably more destructive. Classical deterrence does not depend on retribution being instantaneous or in kind—only certain.

Postulated treaty evaders are of three types. Two—the rogue and the high-tech state—will secretly develop new nuclear devices. The third—by implication, Russia or China—will have held back a sizable arsenal from the weapons dismantling process. From the Western standpoint, the rogue state is dangerous because it may not observe conventional calculations of national self-interest. But few such states will exist, and they will be particularly closely monitored and vulnerable to ongoing sanctions. If a state does achieve breakout, it will still have to solve the problem of translating its monopoly into practical gains. And even if irrationality prevails and one or even several weapons are detonated, the resultant calamity would be comparable, in global terms, to a range of natural and man-made disasters that, unlike a nuclear exchange, world society has shown it can tolerate.

In the case of a high-tech evader, the danger is said to be strategic instability, as other powers scramble to develop a countervailing capability, generating pressure for a preemptive strike. But the worst-case analysts make no attempt to identify the net balance of incentives that would prompt a high-tech state to embark on such a damaging course of action in the first place or to justify the risks involved in a

preemptive strike. And, again, if the worst did happen, the resultant devastation would be small compared with the effects of a nuclear exchange between fully developed arsenals of the kind that existed in the past and are likely to reemerge in the future.

A net incentive to cheat arguably exists for the third category of evader, at least for Russia. Moscow might deem it prudent to secrete some weapons from its dwindling arsenal as insurance against future developments in China. But such a deterrent to Chinese invasion could be used only once before being matched, and, besides, armed invasion poses less of a threat to Russian territory than occupation by illegal immigrants. Russian leaders would surely have thought of all that before signing the treaty, in which case the danger of nuclear war must have taken precedence over the potential threat from China.

In sum, the threat of breakout from a nuclear-free world is neither as substantial nor as potentially calamitous as is usually depicted and is certainly not enough to deep-six the concept. To be sure, a successful breakout would pose a danger to a nuclear-free regime. But that danger must be set against the equally real danger of a nuclear exchange inherent in a nuclear world.

The Beginning of a New Era

We have reached an unusual juncture in world affairs. One distinct and turbulent era has come to an end. The next has yet to take shape. We have the opportunity to make a real choice about the future of nuclear weapons. We cannot choose the status quo. In the long run, we will be unable to prevent proliferation. Our current low-salience nuclear world will become a world of many nuclear states. The strategic arms race will begin anew, and with it the danger of inadvertent or accidental nuclear war.

If we were to adopt the goal of a nuclear-weapons-free world, halting proliferation would become more feasible and the world would grow progressively less dangerous. Even the threat of nuclear breakout turns out to be less ominous than generally claimed—certainly less calamitous than the nuclear exchange latent in a nuclear-weapons world—and assuredly not of a kind to render the concept infeasible. And the prospects that the United States and the other nuclear states will come to see a nuclear-free world as being to their advantage also turn out to be surprisingly favorable.

Eliminating the danger of nuclear war is one reason why a nuclear-free world is desirable. Another, and one that should be of particular interest to the West, is that the process of working toward a nuclear-free world would greatly reinforce the slowly growing international structure of laws that constrain state behavior and reduce the incentive to resort to force.

Today the Western alliance, which currently embraces much of Asia, is singularly well placed to embark on establishing such a regime. We would not be seeking to achieve a nuclear-free world overnight, but over some 20–30 years. The process would itself be continuously reshaping the international political environment in a way generally favorable to achieving its goal. Nor need we be sure of the exact path to follow or even of immediate success before we set out.

The goal is all-important. The alternative to a nuclear-free world is not the reassuring low-salience nuclear world we live in today. Today's nuclear world is inherently unsustainable. The future will be either a nuclear-free world or a high-salience nuclear world. A unique confluence of events extracted us from one high-salience nuclear world, but if we fail to take radical action, there are no good reasons why we will not revert to that dangerous state.

The only way to avoid taking that terrible step backward is to adopt the firm and serious goal of a nuclear-weapons-free world and then to strive mightily to achieve it. ■



TOGETHER AGAIN

THE FISCAL COST OF GERMAN UNITY

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ULLRICH HEILEMANN AND
WOLFGANG H. REINICKE

Ullrich Heilemann is the vice president of the Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen.

Wolfgang H. Reinicke is a research associate in the Brookings Foreign Policy Studies program. They are the authors of Welcome to Hard Times: The Fiscal Consequences of German Unity (Brookings/American Institute for Contemporary German Studies, 1995), from which this article is adapted.

he formal reunification of East and West Germany on October 3, 1990, was the culmination of a decades-long German dream. And Germans have since made remarkable progress in reintegrating two societies whose paths had diverged sharply since World War II. East and west now enjoy common political and judicial institutions and processes, as well as sharing the same social network. Eastern Germany is now fully integrated into the revenue equalization scheme between the Länder (states) and the federal government. The overall income differential, 55 percent in 1990, has narrowed to 25 percent.

But much remains to be done. For the most part, the societal and political elites in the east have remained western "imports," often leading to resentment and feeling of inferiority among large segments of the population. "Second-class citizen" remains a term often used in the ongoing debate over the true extent of the success of German unification. Tellingly, in the general election last October, 17.5 percent of the electorate in the former East Germany (but less than 1 percent in the west) gave their vote to the Party of Democratic Socialism (PDS), the successor of the former communist party. And East Germany's continuing difficulties in finding its proper place in the national and international division of labor has led to unemployment rates that are often more than twice as high as the average in western Germany.

Unification has been costly to both societies. Many in the East suffered not only job losses, especially heavy for women, but also drastic downward mobility. In addition, the sudden loss of identity and belonging and the constant presence of risk associated with a market environment generated feelings of unease and insecurity among many East Germans. Though less sociological and psychological in nature, the cost to western Germany has also been enormous. Each year since 1990 western Germany has transferred about DM 150 billion (\$100 billion at an exchange rate of DM 1.50 per dollar), or 5 percent of its GNP, to the east—an infusion of resources that eastern Germany is certain to need until the end of the century. Like most

of the world's industrialized countries, Germany faces high government deficits, increasing government debts, slow growth, and rising unemployment. Can it make its way through that economic thicket and maintain the massive fiscal transfers to the east?

Nobody Knew How Hard It Would Be

Though West Germany's deficit, like that of many other industrialized countries, deteriorated in the early 1980s, policymakers succeeded not only in reversing that trend, but also in reducing taxes. By 1989, when the Berlin Wall fell and hopes for reunification began to mount, West Germany had transformed its 1981 deficit of DM 57 billion, 3.8 percent of GNP, into a budget surplus of DM 2.8 billion, or 0.1 percent of GNP.

But the German government of Chancellor Helmut Kohl seriously misjudged the economic implications of unification, not only initially but well into 1992. The government's decision to rule out tax increases to finance unification carried it handily through the 1990 all-Germany election campaign but then quickly became a serious handicap for fiscal policies thereafter.

The government was not alone in its optimism about unification. With few exceptions, analysts considered the burdens of financing unification minor and easily manageable. One problem was that unification took place so quickly. It was next to impossible to make a reliable estimate of the financial transfers needed by the new eastern states before the end of October 1990, by which time the legal framework of unification had already been established. In addition, serious mistakes were made in evaluating the east's competitiveness, its adjustment and infrastructure needs, and the extent to which its public sector would have to be scaled back. And few predicted either the breakdown of the Eastern European and former Soviet markets that had been the destination of so much of eastern Germany's output or the unusually long global recession of the early 1990s.

But if western Germans were not at first aware how



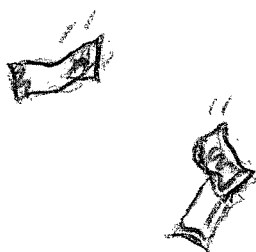
formidable a task they faced in reunification, they know now. Of the DM 150 billion transferred (on average) by the German government to eastern Germany each year, about 40 percent has been financed through deficit spending and the rest by cuts in expenditures (about 10 percent), tax increases (about 25 percent), and increases in social security contributions (about 25 percent). As a result, the public share of western German GNP rose from 45.3 percent in 1989 to 51.6 percent in 1994, and the share of taxes and social security contributions from 40.4 percent to 44.5 percent. The fiscal stimulus from the massive deficit spending caused Germany's GNP growth to accelerate between 1990 and 1992 by an average of 1.5–2.0 percentage points a year. Government debt as a share of GNP climbed from 41.3 percent in 1989 to just under 60 percent in 1994, its highest level in postwar German history. By mid-1992, as most other major nations were recovering from their recessionary slumps, Germany fell into its steepest recession since World War II.

Meanwhile, the rising deficits had—and still have—almost entirely deprived federal, state, and local German governments of their ability to engage in any kind of expansionary or growth-oriented policy. By 1994 interest on the federal public debt accounted for more than 11.0 percent of government spending, while public investment amounted to only 7.5 percent. Meanwhile, tax rates are expected to remain high, and real per capita net income in western Germany was scarcely higher in 1994 than it was in 1989.

Current Perspectives

In 1994 western Germany experienced an unexpectedly high real GNP growth of more than 2 percent. But productivity gains and a growing labor force further increased unemployment by some 300,000 people in 1994, creating a record high unemployment rate of 8.3 percent.

Even from a five-year perspective, Germany's economic and fiscal prospects are daunting. Western Ger-



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many is unlikely soon to recoup the ground lost in the recession and return to the long-term growth path of 2.0–2.5 percent of real GNP that it achieved between 1980 and 1990; even if it could, unemployment would still exceed 7.5 percent. Not only will unemployment stay high, but also, with population rising, real gross per capita income will grow, at best, 1 percent a year. In net terms it may even stagnate or decline. The government's current fiscal plan calls for drastic reduction of the deficit—from 4.5 percent of GNP in 1993 to 1.8 percent by 1997. Even so, the debt-GNP ratio will fall only from 60 percent to 56 percent. Germany will lose its long-held lead within the European Union with respect to the ratio of its deficit and debt to GNP, though the government expects to fall short of the goals for those two ratios established by the Maastricht Treaty only in 1994 (for the deficit) and in 1995 (for the debt).

The price for the rapid deficit reduction envisioned by the government will be high: until 1997 spending growth will be held more than 2.5 percentage points below the growth of nominal GNP. Because eastern Germany's transfer needs will remain high for the rest of the decade, western Germany may well experience on average nominally stagnant or even falling government spending.

Spending Cuts and Tax Hikes

Planned government spending cuts include a freeze of real salaries for civil servants and a reduction of staff, cuts in agriculture, manufacturing, and mining subsidies, in unemployment-related spending, and in family, social, and educational support. On the investment side, major cuts are planned in federal spending for local transport, student loans, defense, residential construction subsidies, and relocating the federal government to Berlin. Investment spending by the government is expected to fall from 14.8 percent to 13.1 percent of total government spending, with a still more significant reduction of investments to take place at the local level. Both reductions, which are anything but attractive from a growth perspective, are necessitated by an increase in government consumption, in particular interest on the debt and additional allocations to the Debt Redemption Fund (the consolidated sum of all unification-related public debts) and the pension insurance fund. Added revenues are expected from a reduction in tax abuse and evasion, from the reintroduction this year of a 7.5 percent "solidarity surcharge" on income taxes (initially imposed in July of 1991 but canceled in June 1992), and from increases in property taxes and the tax levied on consumer purchases of private insurance. The GNP share of social security contributions will rise from 17.2 percent in 1990 to 20 percent in 1997, and that of taxes from 23 percent to 26 percent, 2 percentage points of which will be in the form of "hidden taxes"—"bracket creep" resulting from inflation.

German households and businesses and the international community will be affected in different ways by these policies. The spending cuts, most of which are regressive, will have the harshest effect on lower-income households. Businesses, and thus employment, will be directly affected by cuts in defense and manufacturing subsidies. The tax increases will be felt most keenly by upper-income households, who had earlier been spared their full share of the financial burden of unification. (Initially, that burden fell

disproportionately on workers making social security contributions and thus favored civil servants and the self-employed, who do not make social security contributions, and upper-income workers, whose salaries are partly exempt from those contributions.) The macroeconomic effects—primarily slower growth and higher taxes—of Germany's consolidation policies will not reach the international community as a whole, though neighboring countries in the European Union may well feel them.

Policy Recommendations

The German government's commitment to its goal of deficit and debt reduction implies a continued excessive tax burden that raises doubts about Germany's ability to sustain its already modest prospects for economic growth. Because the most promising long-term path toward lasting fiscal consolidation is strong economic growth, German policymakers must make a greater effort to scrutinize the budget for ways to spur growth. Germany's outstanding record of fiscal responsibility should permit a less ambitious deficit reduction target, especially if the resulting policy latitude allows for corporate and personal income tax cuts.

Current fiscal planning more or less exhausts the existing options for Germany's fiscal stance. Although there is still some room to increase revenues, the amount to be raised will hardly exceed DM 35 billion. These additional revenues should be used either to reduce social security contributions to pre-unification levels or to cut taxes, currently at a level reached only in the mid-1970s, when Germany was trying to consolidate a deficit accumulated in the wake of the 1973 oil crisis. The government should publicly commit itself to a timely reduction of the level of taxation, in particular by reducing direct taxes. The current high level of taxes provides little incentive either to work or to invest. It tends to encourage further growth of the shadow economy, and, on a more general level, to nourish fears of a permanently higher public-sector share of GNP. In addition, policymakers should justify any continuation of the solidarity surcharge beyond 1995.

The implications of the government's fiscal plan on the spending side are equally worrisome. Plans to keep spending growth more than 2 percentage points below the growth rate of GNP for the foreseeable future are extremely ambitious and will not be achieved without impairing economic growth. The consequences for growth would be especially adverse for western Germany, where many spending categories would have to be cut in real, and possibly even nominal, terms, because of the disproportional needs in eastern Germany. Even if interest rates fall as a result of deficit reduction, they cannot be expected to compensate for or even significantly offset the considerable contractive effects of deficit reduction.

True, not all spending cuts would slow economic growth. But it should be remembered that, at least in the early years, the financial burden of unification was not distributed evenly across all social groups, and some of the planned spending cuts, as in public transport and labor market assistance, will adversely affect the same groups hurt initially. Therefore the increase in unemployment insurance contribution rates introduced by the government should be reverted. Other cuts that are unlikely to affect growth can be made in programs that promote per-

sonal saving, construction of housing, and subsidies, thus saving about DM 3.5–5 billion, or 0.2 percent of total spending. But even with these additional cuts—most of which would have to be made in western Germany—the reductions in public services planned by the government would almost certainly endanger long-term economic growth. Thus, if the continuation of economic growth and productivity increases requires additional spending in such areas as research and development, investment, and education, the government should accept any resulting deficits—unlikely in any case to exceed 0.5 percent of GNP. Moreover, given the pivotal role of western Germany's economy for economic prospects in eastern Germany, additional spending here may actually reduce the fiscal dilemma in the medium term.

Keeping the Maastricht Goals in Perspective

The government has justified its unusually stringent deficit reduction plans by pointing to the requirements for European Economic and Monetary Union, in particular the Maastricht criteria. But even if the government's goal of a deficit share of GNP of less than 2 percent by 1997 were relaxed to 2.5 percent, the Maastricht goals would still be met. And such a relaxation would give policymakers an additional DM 30 billion—roughly equivalent to what could be raised through additional revenues and far in excess of what could be raised by additional spending cuts—with which to adjust policies on both the income and the spending side. At the same time, carefully planned income and spending policy measures could stimulate growth and result in a deficit less than 2.5 percent of GNP by 1997. Excessive concern about the Maastricht goals also prevents the government from taking into account the central role that the German economy plays in the European economy and in Europe's overall fiscal health: a 1 percentage point increase in Germany's growth rate leads to a 0.2 percentage point higher growth rate, and an additional DM 6 billion in government revenues, in the European Union as a whole.

Reducing the current high level of taxation would not only improve Germany's competitiveness, but also prevent the high costs of reunification from making today's unusually high share of government spending a permanent feature of the German economy. The overall goal of domestic growth simply must be given much greater consideration. The needs of Germany, Europe, and the international community are more important than an arbitrary deficit goal set at a time when both the costs and the time frame of unification were still unclear. In the end, the Maastricht ratios, like other fiscal indicators, should play only an instrumental role in fiscal policymaking.

We do not in any way mean to downplay what is indeed a serious problem for Germany. Meeting the economic and fiscal challenges ahead successfully will probably require a greater effort than has ever been necessary in the history of the Federal Republic. However confidently and adroitly Germany's politicians handle unification and its attendant fiscal challenges, Germans face a period of economic development that is below their expectations—and certainly below the country's possibilities. But the distresses to be encountered, when measured against the resources available to bear them, are well within Germany's capacity. ■

The Outbreak of Pesophobia

BY NORA LUSTIG



The Mexican peso crisis has left many analysts and investors bewildered. Early last spring some economists contended that the peso was overvalued and as such was curbing Mexico's growth potential. Left uncorrected, they said, the overvaluation could lead to a speculative attack that international reserves held at the Bank of Mexico were too low to stop. The solution? The government should negotiate a devaluation with labor and business leaders to ensure that prices and wages would be raised only moderately, thus curbing inflationary pressures. Following an inevitable jump in prices and perhaps a short-lived recession, said the experts, the devaluation would yield the textbook results: export and output expansion. By dragging their feet, Mexican authorities were only making matters worse.

But when authorities devalued the peso on December 20, what followed was a debacle. Far from calming the markets, the devaluation led to a financial "meltdown" with big spillover effects on other countries, particularly in Latin America. What had been intended as a 20 percent decline in the value of the peso to wipe out excessive imports quickly put Mexico on the verge of default.

Why did capital markets react so fiercely? A mixture of anger, fear, and uncertainty drove investors. Many felt that the Mexican government had broken a promise not to devalue the peso. They also questioned the government's decision not to defend the currency by raising interest rates, particularly in November, when reserves were falling and rising U.S. interest rates were pulling money out of Mexico. The absence of a coherent contingency plan to deal with the sharp loss of international reserves and the aftermath of the devaluation further eroded investor confidence.

When investors began to add up Mexico's foreign-held short-term obligations due to mature in 1995, the numbers quickly surpassed \$50 billion. Mexico's reserves, meanwhile, were barely above \$6 billion and an initial international rescue package of swaplines was \$18 billion. Fearful that the Mexican government would have to default, investors tried to get out while they could.

Mexico's short-term liquidity crunch was largely the result of the government's decision to allow the replacement of almost the entire stock of peso-denominated short-term government securities held by foreigners with instruments indexed to the dollar. These now-famous TESOBONOS insured investors against devaluation, but also carried with them a high risk for Mexico: what if foreign creditors were unwilling to roll the TESOBONOS over when they matured in 1995?

To keep what started as a liquidity crisis from becoming a solvency crisis, Mexico needed a loan from official sources large enough to allow it to convert the short-term obligations into medium-term ones. As events of the first weeks of 1995 showed, that was not easy. Financial constraints kept the International Monetary Fund from becoming lender of last resort; political constraints did the same for the U.S. government. With much effort, the IMF, the United States, other industrialized nations, and even some Latin American ones put together a rescue package of about \$50 billion. Even so, the lack of confidence prevalent in world capital markets forced Mexico to undertake draconian measures—as this goes to press, interest rates have soared higher than 50 percent a year—to restore investor confidence.

Why were Mexican authorities slow to confront the crisis in the making? According to the

Bank of Mexico's president, monetary authorities saw the drop in international reserves as a result of political shocks in 1994, such as the Chiapas uprising, whose effect on confidence would be temporary. Once the new government took office after the mid-August elections and showed its commitment to fiscal prudence and market-oriented reforms, capital flows would return. Because exports were growing briskly, the bank never believed that the peso was overvalued. If the loss of reserves was temporary, why devalue the peso and risk higher inflation? Why let interest rates rise and risk a recession? Erring on the optimistic side turned out to be a fatal mistake.

The strategy of resisting devaluation was surely driven in part by the elections and by then-President Salinas's candidacy to head the World Trade Organization. But once the elections were over, the strategy remained in place. Perhaps officials were concerned that higher interest rates would damage a fragile banking sector.

One key lesson of the crisis is a reminder that economic fundamentals go beyond fiscal prudence and the commitment to open trade. The term structure of public and private debt, the health of a nation's financial and banking sectors, and, above all, mutually consistent monetary, fiscal, and exchange policy are crucial to economic soundness. Another lesson is that capital markets are unlikely to treat a devaluation in countries like Mexico as they would one in the United Kingdom. For those countries, pegged exchange rates if not backed by an international lender of last resort may lead to recurrent crises of confidence. Finally, the peso crisis has underscored the difficulties faced by the existing institutional international arrangements to prevent or manage financial crisis in today's world. ■

Nora Lustig is a senior fellow in the Brookings Foreign Policy Studies program. She is the author of Mexico: The Remaking of an Economy (Brookings, 1992) and editor of Coping with Austerity: Poverty and Inequality in Latin America (Brookings, 1995).

Regulatory Retrenchment

BY PIETRO S. NIVOLA

"Revolutionary." Pundits have been attaching this adjective to the Republican "Contract with America" as though that document were the most radical manifesto since Tom Paine wrote *Common Sense*. In truth, although many House Republicans may share Paine's conviction that "government, even in its best state, is but a necessary evil," their master plan actually leaves intact a lot of government at its worst. Nowhere is this more apparent than in the contract's proposed solution to the problem of bureaucratic overregulation of the private sector.

Federal regulations cost Americans at least a half-trillion dollars a year. To put matters in perspective, the projected annual costs (in excess of benefits) of the 1990 Clean Air Act alone exceed the estimated value of U.S. exports blocked by all of Japan's known import restrictions. Much of this home-made burden is grossly inefficient for the U.S. economy, competing, as it must, in a global marketplace. Relief from the domestic regulatory millstone is, rightly, near the top of the 104th Congress's agenda.

But the way to provide it is not just by declaring another regulatory "moratorium," grandfathering ill-conceived mandates already on the books, and then relying (as the contract does too heavily) on bureaucrats to supply more "analysis" of the strictures they might promulgate in the future.

The way to reform the regulatory state is to really roll it back by challenging some of the basic goals and many of the methods in existing programs.

At bottom, the trouble with much regulation has less to do with overzealous administrators than with unreasonable rules

imposed by legislators. Some of their statutes expressly forbid agencies from considering economic consequences when setting standards. Some literally try to outlaw every risk, no matter how small, at any price: *no* carcinogenic additives in food, *zero* pollutants into rivers, and so on. So instructed, even a Solomonic agency is enjoined from regulating sensibly. A revolutionary Congress would revoke such misbegotten marching orders in current law, not just hope that more "risk assessments" and "impact" statements will sanitize subsequent measures.

The contract does call for capping the compliance costs of all regulatory activities below their current levels. But that scarcely guarantees that agencies will be forced to find more cost-effective means of performing their present tasks. The measurement of costs, not to mention benefits, of regulations can vary wildly depending on who's doing the measuring. Not too long ago, the Environmental Protection Agency estimated the yearly costs of complying with a proposed ambient air quality standard to be half the figure estimated by industry. Meanwhile, the Consumer Product Safety Commission debated whether the compliance cost of a fabric flammability rule should be counted in millions of dollars or in billions, as regulatees insisted.

Why the Republicans, so far, have seemed more eager to oversee tomorrow's regulations than to dismantle today's is not always easy to understand. A cynic might suspect it's because the GOP has fingerprints all over much of the extant regime. (Republican presidents signed off on such projects as the costly Clean Air Act amendments, the litigious 1991 Civil Rights Act, the minority set-asides in

federal contracting, and the most recent mother of all mandates, the Americans with Disabilities Act.) But another explanation may be that repealing bad laws frequently means finding better substitutes—a tall, if not impossible, order given the Republican dogma on new taxes.

Some regulatory functions, after all, serve a legitimate public purpose, at least if carried out less legalistically and less wastefully. For example, key resources, such as water and some forms of energy, are still priced below their true economic value in certain parts of the country, leading to excessive consumption and serious environmental degradation. Where the use of these resources is inadequately rationed by market forces, additional restraint may be necessary.

But in these cases, charging user fees (in plain English, raising excise taxes) can be at once less intrusive and more efficient than resorting to Byzantine commands and controls enforced by prosecutions, fines, or jail terms. For example, a gasoline levy of only 25 cents per gallon would have saved as much oil, at a third the social cost, as the government's principal energy conservation program, the federal fuel economy requirements for automobile manufacturers.

Abolishing such cumbersome bureaucratic controls and simply substituting excises could also help the Republican Congress meet some other contractual obligations—like offsetting revenue shortfalls from proposed reductions in the far more damaging taxes on capital gains and savings.

The Republican lawmakers could use a bit less anti-tax orthodoxy if they decide to revisit several entrenched regulatory policies more boldly later this year. That's, well, common sense. ■



Pietro S. Nivola is a senior fellow in the Governmental Studies program. He is the coauthor, with Robert W. Crandall, of The Extra Mile: Rethinking Energy Policy for Automotive Transportation, a Twentieth Century Fund Book (Brookings, 1995).

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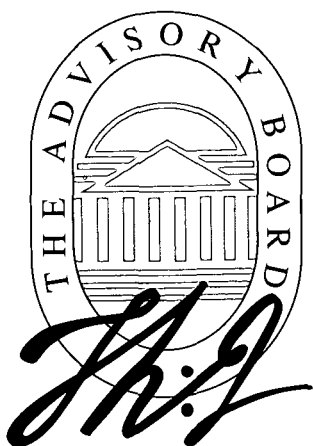
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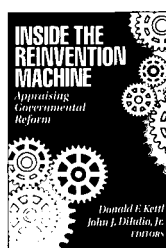
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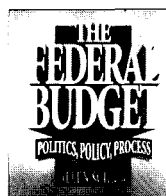


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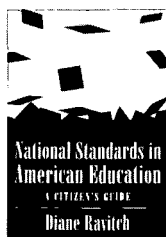


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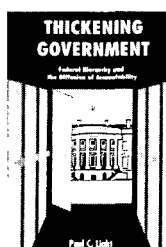


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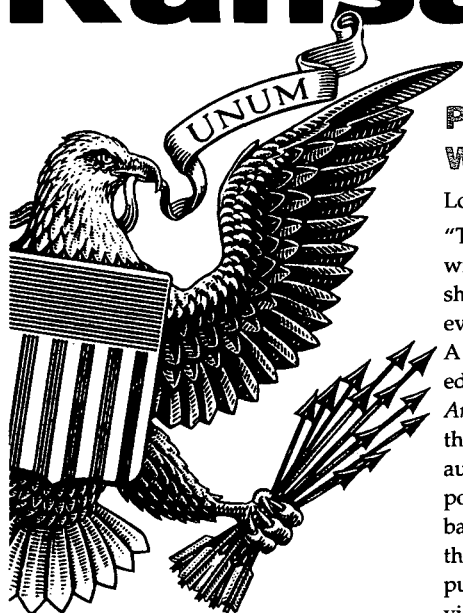
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